SECURITIES—COMMODITIES ACCORD AMENDMENTS OF 1982

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2260

TO CLARIFY THE JURISDICTIONAL BOUNDARIES BETWEEN THE SECURITIES AND EXCHANGE COMMISSION AND THE COMMODITY FUTURES TRADING COMMISSION

MARCH 31, 1982

Printed for the use of the
Committee on Banking, Housing, and Urban Affairs

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SECURITIES—COMMODITIES ACCORD AMENDMENTS OF 1982

WEDNESDAY, MARCH 31, 1982

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met at 9:30 a.m., in room 5302, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The subcommittee will come to order.

Today the Subcommittee on Securities will hear testimony on S. 2260, a bill which Senator Lugar and I introduced. The bill, along with companion amendments to the commodities laws being considered by the Agriculture Committee, will implement the agreement reached by the Securities and Exchange Commission and the Commodity Futures Trading Commission to resolve jurisdictional issues between the two agencies.

Before commenting on the substance of these bills, I want to commend the chairmen of the two agencies and the other commissioners as well, for reaching this agreement and presenting it to the Congress.

The jurisdictional issues between the SEC and the CFTC are complex and have built up over several years. The two agencies, under the outstanding leadership of Chairman Shad and Chairman Johnson, made great progress in a matter of months in reaching this accord.

In the absence of such an accord, the securities and futures markets have been plagued by uncertainty and confusion, with the two agencies at times even taking conflicting positions. It's no wonder in this environment that lawsuits have proliferated and the introduction of new products has been frustrated.

While the jurisdictional agreement does not resolve every potential ambiguity in the relationship between the SEC and the CFTC, it goes a long way toward resolving the areas of greatest controversy at this time. Moreover, the jurisdictional agreement has set a pattern of cooperation which I hope will continue as other issues arise.

For, as new products and services emerge, and as the two agencies monitor developments under the accord, there will be a continuing need for consultation and cooperation. Chairman Shad and

Chairman Johnson have established that they are committed to that process.

Both the regulatory agencies and the Congress will have the opportunity and responsibility to monitor new trading instruments to assure that their development is consistent with the purposes of the Federal securities and commodities laws. Under these circumstances, I believe that approval of S. 2260 and the other parts of the agreement is an appropriate step to take.

[A copy of S. 2260 and a joint explanatory statement by the Securities Exchange Commission and the Commodities Futures Trading Commission explaining the jurisdictional agreement follow:]

97TH CONGRESS
2D SESSION

S. 2260

Entitled: "Securities—Commodities Accord Amendments of 1982."

IN THE SENATE OF THE UNITED STATES

MARCH 23 (legislative day, FEBRUARY 22), 1982

Mr. D'AMATO (for himself and Mr. LUGAR) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

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A BILL

Entitled: "Securities—Commodities Accord Amendments of 1982."

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Securities—Commodities Accord Amendments of 1982".

SEC. 2. Section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b(1)) is amended by inserting after "mineral rights," the following: "any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

Sec. 3. Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)) is amended by inserting after "for a security," the following: "any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

Sec. 4. Section 9 of the Securities Exchange Act of 1934 (15 U.S.C. 78i) is amended—

(1) by striking out "this section" in subsection (f) and inserting in lieu thereof "subsection (a)"; and

(2) by inserting after subsection (f) the following new subsection:

"(g) Notwithstanding any other provision of law, the Commission shall have the authority to regulate the trading of any option on a security or on a certificate of deposit (but not an option on a contract for future delivery).".

Sec. 5. Section 2(a)(36) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(36)) is amended by inserting after "mineral rights," the following: "any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

SEC. 6. Section 202(a)(18) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(18)) is amended by inserting after "mineral rights," the following: "any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

C.F.T.C.
RELEASE NO. 883-82

S.E.C.
RELEASE NO. 82-9

N E W S from the — United States Securities and Exchange Commission
United States Commodity Futures Trading Commission

For Release: Tuesday, February 2, 1982

For Further Information Contact:

Andrew Rothman (S.E.C.)	202-272-2650
Laurie Buchanan (C.F.T.C.)	202-254-8630

SEC and CFTC JURISDICTIONAL AGREEMENT: PROPOSED LEGISLATION

The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) announced today that they have agreed on proposed legislation to codify the previously announced agreement on the range of issues regarding the jurisdiction of so-called financial instruments and various related matters.

On December 7, 1981, the two agencies announced that following discussions between SEC Chairman John S.R. Shad and CFTC Chairman Philip McB. Johnson, the Commissions had agreed to certain jurisdictional proposals on their respective regulatory responsibilities and would seek to codify that agreement formally. Since that time each agency has prepared legislative amendments to the affected statutes. Each agency has submitted the draft legislative proposals (a copy of which is attached) to their respective Congressional oversight committees.

Attachment

# # #

Commodity Futures
Trading Commission

Securities and Exchange
Commission

JOINT EXPLANATORY STATEMENT

As announced on December 7, 1981, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") have come to an agreement on a range of issues regarding their respective jurisdictions. In connection with this effort, the agencies have prepared draft legislation which, among other things, would clarify the statutes administered by the two agencies. The CFTC and the SEC are transmitting the draft legislative proposals to their respective Congressional committees, with this Statement, which explains a number of issues relating to the agreement. The two agencies urge that these statutory changes be enacted as promptly as possible.

The desirability of a resolution by the two agencies of the issues between them has become increasingly clear. The growing demand for new products related to securities or financial instruments, either as investments or as price hedging tools, has magnified the importance of removing the jurisdictional confusion that has hampered the development of the markets for such instruments. The confusion is a result essentially of amendments in 1974 to the Commodity Exchange Act (the "CEA") that (1) expanded the definition of "commodity" to embrace not only tangible goods but to reach intangible rights and interests, (2) gave the CFTC "exclusive jurisdiction" over agreements and transactions "involving" futures trading in commodities, and (3) inserted in the CEA a qualified proviso to preserve the SEC's pre-existing authority over securities trading and the securities markets.

Summary

The two agencies have agreed that the SEC will regulate options on securities and on certificates of deposit (and on all groups or indices of securities or certificates of deposit) and the CFTC will regulate futures contracts on exempted securities (other than municipal securities) and on broad-based groups or indices of any securities, as well as options on any such futures contracts. No futures contracts (or options on futures contracts) on individual corporate and municipal securities will be permitted to trade. The SEC may also allow options on foreign currency to trade on national securities exchanges, while the CFTC will have jurisdiction to regulate the trading of options on foreign currency in the commodities markets. The attached legislative proposals would specifically codify the agreement of the two agencies by clarifying current law in certain areas.

* * * *

Options on securities

Since 1973, national securities exchanges have traded options on securities under the regulatory structure administered by the SEC. The proposals to amend the federal securities laws would relate to the SEC's authority to regulate trading in options on securities. The SEC's authority over such trading on exempted securities has been challenged in the United States Court of Appeals for the Seventh Circuit. 1/ Thus, one proposal would clarify the definition of "security" in the federal securities laws to include explicitly any option on a security. 2/ In addition, options on foreign currency traded on a national securities exchange and options on certificates of deposit 3/ would be included within that definition.

1/ Board of Trade of the City of Chicago v. Securities and Exchange Commission, et al., No. 81-1660 (7th Cir., petition for review filed April 24, 1981), (No. 81-2587 (7th Cir., petition for review filed October 5, 1981); and No. 82-1097 (7th Cir., petition for review filed January 21, 1982).

2/ As a result, an option on an exempted security would expressly be a separate, non-exempted security. Accordingly, a person in the business of effecting transactions in such instruments would, absent an applicable exemption, be required, pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act"), to register with the SEC as a broker or dealer. To the extent, however, that such a requirement would impose an unnecessary burden on government securities dealers effecting transactions in options on government securities, the SEC has the authority administratively to provide an exemption from that requirement and currently intends to do so.

3/ Although the status of certificates of deposit as securities under the Securities Act of 1933 (the "Securities Act") and the Exchange Act is not free from doubt, certificates of deposit have consistently

(footnote continued)

Under the proposals, the SEC's authority over the trading of securities options also would be clarified by an amendment to Section 9(f) to establish specifically that the SEC's plenary options authority in Section 9(b) of the Exchange Act extends to options on exempted securities and by the addition of Section 9(g) which confirms the SEC's authority to regulate the trading of options on all securities and on certificates of deposit. The same legislative proposal would provide that only the SEC, and not the CFTC, has authority with respect to options directly on underlying securities and securities groups or indices.

* * * *

Under a series of proposed amendments to the federal commodity laws, the CEA would not apply to options on securities or securities aggregates, and the CFTC would not be permitted to designate a board of trade as a contract market for the trading of such instruments. Nevertheless,

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3/ (footnote continued)

been considered "securities" for the purposes of the Investment Company Act of 1940. In order to emphasize that no change in current law is contemplated, the legislative language used in the two circumstances differs. Thus, for investment company purposes, the relevant portion of the definition of security would read "* * * option * * * on any security including a certificate of deposit," while the corresponding language proposed in the Securities and Exchange Act would read " * * * option * * * on any security, or certificate of deposit * * *."

the CFTC would have exclusive jurisdiction over all permissible futures contracts as well as options on those futures contracts, and would regulate options directly on foreign currencies traded in the commodity markets (but not on a national securities exchange).

Futures on individual corporate or municipal securities

Pending further review of appropriate regulatory systems for trading in such futures, the legislative proposal would foreclose the trading of futures (and options on futures) on individual corporate or municipal securities, or contracts based on the value of such a security. Nevertheless, the two agencies intend to study further the issues raised by such trading with a view toward a future recommendation to lift this restriction. This temporary foreclosure of trading does not apply to futures (or options on futures) on exempted securities, except municipal securities.

Futures on securities indices

The CFTC would be permitted under proposed amendments to the CEA to designate a board of trade as a contract market for contracts (or options on such contracts) of sale for future delivery of a securities group or index, but only if the contract (or option on such contract) meets certain specific minimum requirements set forth in the draft legislation as well as other requirements currently in the CEA.

With respect to a futures contract on a securities group or index (or option on such contract), settlement must be effected in cash or by means other than a security on which a futures contract could not be authorized. That is, such a contract could be settled by delivery of an exempted security, such as a security issued or guaranteed by the United States government, but could not be settled by the transfer or receipt of a corporate or municipal security.

Separate and apart from the present statutory requirement that any contract market have rules to prevent manipulation, the CFTC also would be required to find that trading in the contract under consideration would not be likely to produce manipulation in the futures markets or in related markets, _i.e._, those for any underlying security, option on such security, or option on a group or index including such securities. 4/

A securities group or index underlying a futures contract must be predominantly composed of the securities of unaffiliated issuers and, in addition, would be required to be a widely published measure of, and to reflect, the market for all publicly-traded equity or debt securities or a substantial segment _of_ such market, or be comparable to such

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4/ In order to address concerns relating to the general possibility of inter-market manipulation, the agencies have recommended the CEA be amended to authorize the CFTC to provide trade information to securities self-regulatory organizations and to registered futures associations, as well as to contract markets.

a measure. This standard is intended to provide adequate flexibility for the market to respond to the needs of participants, while assuring that only broad-based securities index futures contracts that are not conducive to manipulation could be authorized. 5/

In view of the SEC's strong regulatory concern with respect to the trading of futures on securities groups and indices, that agency would be provided a specific role in the process of CFTC designation of a contract market for the trading of such instruments. 6/ The CFTC would

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5/ In practice, the two agencies believe that these standards will raise few substantial questions with respect to trading futures on established, widely-used indices containing a number of securities sufficient so that the indices will not be subject to manipulation. As one example, an index of most of the securities traded on a major national securities exchange would appear unlikely to present difficulties. Such indices also would seem more likely to be useful to the marketplace, since they would permit persons such as underwriters or portfolio managers to hedge the risk of overall market movements. However, it appears unlikely that indices not now in existence, based on bonds issued by a group of affiliated companies or on small industry groups, would meet such standards.

6/ Section 2(a)(8) of the CEA provides a procedure for CFTC solicitation of comments from the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System ("FRB") with respect to futures contracts involving securities issued or guaranteed by the U.S. government. As agencies concerned with the issuance of such securities and with monetary policy and debt management, the Treasury Department and the FRB clearly have an interest in the CFTC's designation of a market for futures on such instruments. Nevertheless, the SEC, as the regulator of trading markets in municipal and corporate securities, has an even more direct interest in the authorization of a related futures market. Thus, the involvement of the SEC in the designation process is intended to go beyond the relatively informal communications procedure established for the Treasury Department and the FRB.

be required to consult with the SEC with respect to designation of any board of trade as a contract market for any futures contract involving a securities group or index. Following a mandatory public comment period, the SEC would be provided with a specific time period during which it could object to the designation on the ground that any minimum requirement was not met. If the SEC objected, the CFTC would, if the SEC requested, afford it an opportunity, after the public comment period, for an oral hearing prior to action upon the designation. After the oral hearing, if the SEC continued to maintain its objections, the CFTC would be required to give appropriate weight to the SEC's views in deciding whether to authorize the contract. If, nonetheless, the CFTC designated a board of trade as a contract market for such a futures contract, 7/ the SEC would have the right to judicial review of such order, at which time the court would consider the CFTC's action and the SEC's views. In reviewing the CFTC action, the court would be required to determine, in accordance with the standards of Section 6(b) of the CEA, whether the agency action was supported by the weight of the evidence.

7/ If the CFTC refused to grant the application for designation and, pursuant to the CEA, afforded the board of trade an opportunity for a hearing on the record, the SEC would have the right to participate in that hearing as an interested party. Thus, the SEC would be permitted to present evidence and its views and to challenge the arguments advanced by the board of trade in support of its application.

Commodity pools

While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts * * * involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, *i.e.*, its formation, capital-raising, and continued corporate existence, are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions therein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act of 1940 and, if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940.

February 1, 1982

Amendments to Commodity Exchange Act
(Submitted by CFTC in connection with its Reauthorization)

COMMODITY EXCHANGE ACT
[New Language Underlined]

Section 2(a)(1)(A)

* * * The word "commodity" shall mean * * * all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in: Provided, That the Commission shall have exclusive jurisdiction, except to the extent otherwise provided in subparagraph (a)(1)(B) of this section, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option," "privilege," "indemnity," "bid," "offer," "put," "call," "advance guaranty," or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to Section 5 of this Act or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 19 of this Act: And provided further, That, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit

the jurisdiction conferred on courts of the United States or any State. Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

* * * * *

Section 2(a)(1)(B)

Nothwithstanding any other provision of law --

(i) This Act shall not apply to and the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call or other option on one or more securities (as defined in Section 2(1) of the Securities Act of 1933 or Section 3(a)(10) of the Securities Exchange Act of 1934 on the effective date of Public Law No.   ), including any group or index of such securities, or any interest therein or based on the value thereof.

(ii) This Act shall apply to and the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option," "privilege," "indemnity," "bid," "offer," "put," "call," "advance guaranty," or "decline guaranty") and transactions involving, and may designate a board of trade as a contract market in, contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereof), provided, however, that no board of trade shall be designated as a contract market with respect to any such contracts of sale (or options on such contracts) for future delivery unless the board of trade making such application demonstrates and the Commission expressly finds that the specific contract (or option on such contract) with respect to which the application has been made meets the following minimum requirements:

(a) Settlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security, except an exempted security under Section 3 of the Securities Act of 1933 or Section 3(a)(12) of the Securities Exchange Act of 1934 as in effect on the effective date of Public Law No. ____ (other than any municipal security, as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 on the effective date of Public Law No. ____);

(b) Trading in such contract (or option on such contract) shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), nor to causing or being used in the manipulation of the price of any underlying security, option on such security or option on a group or index including such securities;

(c) Such group or index of securities shall be predominately composed of the securities of unaffiliated issuers and shall be a widely published measure of, and shall reflect, the market for all publicly traded equity or debt securities or a substantial segment thereof, or shall be comparable to such measure.

(iii) Upon application by a board of trade for designation as a contract market with respect to any contract of sale (or option on such contract) for future delivery involving a group or index of securities, the Commission shall provide an opportunity for public comment on whether such contracts (or options on such contracts) meet the minimum requirements set forth in subparagraph (ii) hereof, and shall consult with the Securities and Exchange Commission with respect to such designation. If, within 15 days following the close of the public comment period, the Securities and Exchange Commission shall object to the designation of a board of trade as a contract market in such contract (or option on such contract) on the ground that any minimum requirement of subparagraph (ii) hereof is not met, the Commission shall afford the

Securities and Exchange Commission an opportunity for an oral hearing, to be transcribed, before the Commission, and shall give appropriate weight to the views of the Securities and Exchange Commission. Such oral hearing shall be held after the public comment period, prior to Commission action upon such designation, and not less than 30 nor more than 45 days after the close of the public comment period, unless both the Commission and the Securities and Exchange Commission otherwise agree. In the event that such an oral hearing is held and the Securities and Exchange Commission fails to withdraw its objections, and the Commission issues an order designating a board of trade as a contract market with respect to any such contract (or option on such contract), the Securities and Exchange Commission shall have the right of judicial review of such order in accordance with the standards of Section 6(b) of this Act. In the event that, pursuant to Section 6 of the Act, there is a hearing on the record with respect to such application for designation, the Securities and Exchange Commission shall have the right to participate in that hearing as an interested party.

(iv) No person shall offer to enter into, enter into, or confirm the execution of any contract of sale (or option on such contract) for future delivery of any security, or interest therein or based on the value thereof, except an exempted security under Section 3 of the Securities Act of 1933 or Section 3(a)(12) of the Securities Exchange Act of 1934 as in effect on the effective date of Public Law No. (other than any municipal security as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 on the effective date of Public Law No.); or except as provided in subparagraph (ii) hereof, any group or index of such securities or any interest therein or based on the value thereof.

Section 4c.

Section 4c(f) Nothing in this Act shall be deemed to govern or in any way be applicable to any transaction in an option on foreign currency traded on a national securities exchange.

[Current Section 4m renumbered 4m(1)]

Section 4m(2) Nothing in this Act shall relieve any person of any obligation or duty, or affect the availability of any right or remedy available to the Securities and Exchange Commission or any private party arising under the Securities Act of 1933 or the Securities Exchange Act of 1934 governing the issuance, offer, purchase or sale of securities of a commodity pool, or persons engaged in transactions with respect to such securities, or reporting by a commodity pool.

Section 8a.

The Commission is authorized --

(6) to communicate to the proper committee or officer of any contract market, registered futures association, or self-regulatory organization as defined in Section 3(a)(26) of the Securities Exchange Act of 1934, notwithstanding the provisions of Section 8 of this Act, the full facts concerning any transaction or market operation, including the names of parties thereto, which in the judgment of the Commission disrupts or tends to disrupt any market or is otherwise harmful or against the best interests of producers, [and] consumers or investors or which is necessary or appropriate to effectuate the purposes of this Act: Provided however, any information furnished by the Commission under this subsection shall not be disclosed by such contract market, registered futures association or self-regulatory organization except in any self-regulatory action or proceeding; and

February 1, 1982

Amendments to the Securities Laws

SECURITIES ACT OF 1933

Section 2

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security or certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

SECURITIES EXCHANGE ACT OF 1934

Section 3(a)

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, or certificate of deposit, or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, warrant or right to subscribe to or purchase any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Section 9

(f) The provisions of [this section] subsection (a) shall not apply to an exempted security.

(g) Notwithstanding any other provision of law the Commission shall have the authority to regulate the trading of any option on a security or on a certificate of deposit (but not an option on a contract for future delivery).

INVESTMENT COMPANY ACT OF 1940

Section 2(a)

(36) "Security" means any note, stock treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security including a certificate of deposit, or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", certificate or interest or participation in, temporary or interim certificate for, receipt for, guarantee of, warrant or right to subscribe to or purchase any of the foregoing.

INVESTMENT ADVISERS ACT OF 1940

Section 202(a)

(19) "Security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security including a certificate of deposit or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to a foreign currency, or, in general, any interest or instrument commonly known as a "security", certificate or interest or participation in, temporary or interim certificate for, receipt for, guarantee of, warrant or right to subscribe to or purchase any of the foregoing.

Senator D'AMATO. Good morning, Chairman Shad. It's good to have you here. I look forward to your testimony.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. SHAD. Thank you, Senator D'Amato.

JURISDICTIONAL DISPUTES

Chairman D'Amato and members of the subcommittee, last year the CFTC and the SEC reached an accord which resolves longstanding jurisdictional disputes between these two agencies. The fundamental issues concern the allocation of jurisdiction over the futures and options markets. A future is a purchase or sale contract for something at a specific price with delivery at a future date. An option is the right to purchase or sell something at a fixed price within a future period. Thus, futures and options are similar, but not identical. Both are used to hedge the risk of future price fluctuations.

The principal concerns of the two agencies have been over the jurisdiction of futures on stock groups and indices and options on Government securities.

The 1974 amendments to the commodities laws granted the CFTC exclusive jurisdiction over futures on commodities and expanded the definition of commodities to include intangible rights and interests.

The legislative history suggests that such authority was not intended to include futures on stocks, but that futures on broad-based stock indexes were contemplated. The accord acknowledges the CFTC's authority to authorize trading of futures on broad-based securities indices.

The SEC has regulated options on corporate securities since 1973, but its jurisdiction over options on Government securities has been challenged in the courts. The initial case was brought last year.

Last week the seventh circuit invalidated the SEC's order which approved trading in GNMA options. In light of the seventh circuit decision, enactment of S. 2260 is essential. It will cure the legal ambiguities which have placed the SEC's jurisdiction in doubt.

Specifically, the accord acknowledges the SEC's jurisdiction over options on corporate, Federal, and municipal government securities, indices, and groups of securities, certificates of deposit, and foreign currencies; and the CFTC's jurisdiction over futures on Federal Government securities, certificates of deposit, and broad-based securities indices, as well as options on foreign currencies and on futures contracts within the CFTC's jurisdiction.

With reference to commodity pools, the accord acknowledges the SEC's jurisdiction over their public offering, registration and reporting requirements and the CFTC's jurisdiction over their operation and management.

And finally, subject to further study, the accord bans futures on corporate and municipal securities.

The Commission has submitted a formal statement for inclusion in the record. Since the SEC does not have jurisdiction over commodity futures and is not intimately familiar with the CFTC's enabling legislation, policies, and practices, it is respectfully requested that questions in these areas be addressed to Chairman Johnson of the CFTC. I will be glad to respond to questions concerning the SEC. Thank you.

[The complete statement follows:]

STATEMENT BY JOHN S.R. SHAD, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, PRESENTED ON MARCH 31, 1982, BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS REGARDING S. 2260

Chairman D'Amato and members of the Subcommittee:

I. INTRODUCTION

The Securities and Exchange Commission is pleased to testify concerning proposed amendments to the securities laws to implement the recent accord between the Securities and Exchange Commission and the Commodity Futures Trading Commission. As you know, on February 2, 1982, the two agencies transmitted to their respective Congressional oversight committees draft legislation to clarify the securities and commodity laws concerning the agencies' authority over the developing markets in futures and options on financial instruments. That draft legislation will resolve ambiguities in the current law governing the jurisdictions of the Commission and the CFTC and thus remove impediments to each agency's ability to discharge its Congressional mandate. The discussions that produced this jurisdictional resolution also have laid the groundwork for further consultation and coordination between the two agencies with respect to other matters of concern.

This legislation represents an accommodation that both agencies believe is in the public interest. In this regard, the legislation resolves certain disputes that have arisen in the past regarding the two agencies' jurisdiction over certain new financial instruments. Moreover, it does so in a manner that recognizes the regulatory concerns of both agencies without disrupting markets that have already developed under the current regulatory framework. Both agencies have indicated that they intend, to the extent consistent with the existing regulatory framework, to adhere to the announced jurisdictional accord in the course of the consideration of new product proposal. In order, however, to implement the accord fully Congressional action is needed. Moreover, enactment of the proposed legislation would cure ambiguities in both the securities and commodities laws which provided the basis for the adverse ruling last week by the Seventh Circuit Court of Appeals concerning the Commission's approval of the Chicago Board Options Exchange's GNMA options program.

A. Background

As the members of the Subcommittee are aware, the past several years have witnessed dramatic changes in the United States economy. Double-digit inflation has been accompanied not only by a rise in interest rates, but also by a substantial increase in their volatility. The breakdown of the Bretton Woods Agreement has exposed all businesses engaged in foreign commerce to the risks of exchange rate fluctuations on a daily basis. The increasing significance of such risks, in turn, has led both businesses and investors to seek means to control risk.

One response has been the emergence, both on securities exchanges and boards of trade, of trading in new instruments which can be used to manage risk. In 1973, trading in standardized options contracts began on the Chicago Board Options Exchange.

Standardized options trading now includes trading in put and call options on the equity securities of over 300 issuers. In 1975, trading began on a board of trade in futures contracts on foreign currency and in the first futures contract on a security -- a mortgage-backed debt security guaranteed by the Government National Mortgage Association (so called "GNMAs"). The CFTC subsequently authorized trading in certain Treasury securities, certificates of deposit, and commercial paper.

Since the initial introduction of new trading instruments that may be used in risk management, the commodities and securities exchanges have become more innovative. For example, the Commission has received proposals to trade options on GNMAs, Treasury instruments, foreign currency, stock groups and stock indices, gold coins, and gold bullion-valued promissory notes. The CFTC has received proposals to trade futures on stock groups and indices and is undertaking a pilot program which will permit boards of trade to engage in trading in options on futures contracts.

The emergence of these new types of trading instruments has blurred the traditional line between securities and commodities. As a result, both the Commission and the CFTC have faced the prospect that the approval of new products could result in a legal challenge. A number of challenges to agency actions have, in fact, been made. For example, the Commission's recent approval of the CBOE's GNMA options program just last week was the subject of an adverse judicial decision.

In order to remove jurisdictional uncertainties and to enhance their ability to evaluate responsibly proposals to trade innovative risk management devices, the Commission and the CFTC determined that the public interest demanded that they reach an agreement on the allocation of jurisdiction between the two agencies. Following a series of meetings between the agencies, an accord was reached and ratified by each commission. The agencies also jointly developed draft legislation which is intended to codify their agreement.

B. Terms and Analysis of the SEC/CFTC Accord

The accord provides that the Commission will regulate options on all securities and certificates of deposit, as well as on all groups or indices of securities or certificates of deposit. The CFTC will regulate futures on exempted securities (other than municipal securities) and on broad-based securities groups and indices, as well as options on such futures. The Commission also may approve and regulate trading in foreign currency options on national securities exchanges, and the CFTC may approve and regulate trading in such options on boards of trade. The accord presently bans the authorization by either agency of futures contracts on individual corporate and municipal securities (and options on such futures contracts), subject to further study. Finally, with respect to commodity pools, the accord provides that nothing in the commodities laws shall affect the applicability of the securities laws to the formation of such pools and the issuance and trading of participation interests in them.

Under the accord, the CFTC will continue to regulate the established futures markets in GNMAs, Treasury instruments, and certificates of deposit. In addition, the Commission's regulatory responsibility with respect to options on individual stocks is undisturbed.

In areas where ambiguities existed, the concerns of each agency were carefully recognized. For example, the Commission, which has traditionally regulated options on equity securities and which has approved options contracts on exempted securities (GNMAs and Treasury securities), is granted sole jurisdiction over options on all securities. In addition, the accord recognizes the Commission's substantial interest in the trading of any type of derivative instrument that involves a nonexempted security.

Accordingly, the CFTC will not be permitted to authorize trading in any securities index futures contract (or option on such a contract), if that trading has the potential for adversely affecting an underlying market regulated by the Commission. Thus, the CFTC will be permitted to authorize trading in futures contracts only on "broad-based" stock groups or indices. In order to qualify as "broad-based," a securities index or group must meet certain minimum standards. Specifically, such an index or group must be a widely published measure of, or reflect, the market for all publicly traded equity or debt securities, or a substantial segment of such a market. In addition, such futures contracts must be settled in cash and cannot be readily susceptible to use in the manipulation of related markets. The CFTC will also be required to consult with the Commission concerning proposals to trade futures on securities indices. Moreover, the Commission will be entitled to an oral hearing to object to a proposal that fails to satisfy these basic qualifications, and could seek judicial review of CFTC action approving a contract to which the Commission objected.

The Commission believes that the new financial instruments approved over the past several years, as well as those with respect to which approval is anticipated as a result of the jurisdictional accord, provide, or have the potential for providing, benefits to the market participants. Both options and futures on financial instruments, such as debt securities and foreign currency, are risk management devices used to hedge against adverse price movements in the underlying instrument or interest rates. For example, broker-dealers utilize futures contracts on securities issued by the U.S. government and federal agencies to hedge positions in corporate bonds, as well as positions in U.S. government securities. Such risk reduction can result in lower costs of underwriting corporate debt securities and, thus, facilitate capital formation by providing greater certainty for both issuers and underwriters as to the cost of debt financings. The recently approved options on Treasury securities offer market participants, such as mortgage bankers and corporate borrowers, as well as bond underwriters seeking to reduce interest rate risk during a distribution, an additional vehicle for hedging against interest rate volatility. Options and futures on stock groups and stock indices offer the opportunity to hedge against general stock market risk, while retaining the opportunity to profit to the extent that particular stocks out-perform the market averages. At the same time, these new financial instruments also offer the opportunity to speculate on a leveraged basis with respect to future developments.

Both agencies have agreed to a ban on the authorization of futures on individual stocks and corporate and municipal bonds, pending further study. It is the Commission's view that, as a theoretical matter, the agency which has authority over the underlying instrument or "commodity" should have authority over all derivative interests in such instrument or "commodity." For example, the SEC has jurisdiction over the registration and reporting requirements for the issuers of, and the markets in, stocks and bonds. The fluctuating market prices of futures on stocks or bonds would be a function of the fluctuating market prices of the underlying instruments. Manipulation of the market in the underlying instrument could affect the market price of the derivative interest and vice versa. Therefore, both markets ideally should be subject to surveillance and regulated by the same agency.

The Commission recognizes, however, that present law reflects a different approach. The Commodity Exchange Act grants the CFTC exclusive jurisdiction over all futures contracts, regardless of the underlying instruments upon which they are based. There may be sound reasons for preserving this principle, although the question is one which merits further review. So far, the securities which have become the subject of futures trading, although subject to general antifraud rules, are exempted from other specific provisions of the securities laws. However, in light of the Commission's historic role in regulating the securities markets, the agencies have agreed that neither will authorize futures on corporate stocks or bonds or municipal securities, pending further study.

II. REGULATORY CONCERNS

The Commission has, in the past, raised concerns with respect to the disparate regulatory structures applicable, on the one hand, to futures on securities and options on those futures and, on the other, to the securities themselves and options on those securities. Certain of these disparities have been addressed in the proposed legislation, and others have been ameliorated by measures taken by the two agencies and the exchanges, since the new financial products were first proposed. Other concerns were beyond the scope of the accord.

A. Surveillance

Substantial progress has been made by the CFTC and the Commission in identifying and addressing manipulation and surveillance concerns associated with related futures and securities products. First, as described above, the proposed legislation includes provisions with respect to futures on securities indices designed to ensure that transactions in such instruments cannot be used to manipulate or destabilize the underlying securities markets. Thus, futures would be permitted on securities groups or indices only if those groups or indices are broad-based and settlement or delivery of such futures contracts would be effected by cash or cash equivalents. These requirements are designed to ensure that the market for a single security, or a small group of securities, could not be disrupted by futures trading. In addition, the proposed legislation specifically will require the CFTC to find that a proposed securities index or group futures contract is not readily susceptible to manipulation, nor to causing or being used to manipulate the price of the underlying security, an option on that security, or an option on the group or index. In addition, the Commission would be provided a specific opportunity to object to any proposal which it perceived had the potential of disrupting securities trading. In the Commission's view, these provisions, taken together, should mitigate substantially the likelihood that trading in futures on securities indices or groups could be used to manipulate or otherwise disrupt markets subject to the oversight of the Commission.

Second, with respect to futures on securities generally, including securities index futures, the proposed legislation would modify the Commodity Exchange Act in a manner designed to permit much closer cooperation between the CFTC, the Commission and the commodities and securities exchanges in the surveillance of their respective markets. Currently, Section 8(e) of the Commodity Exchange Act permits the CFTC to furnish to other government agencies information concerning the trading activity of futures markets participants, but prohibits the Commission from supplying that information to others. Since, under the system of self-regulation in place under the federal securities laws, the national securities exchanges and the National Association of Securities Dealers have primary responsibility for the day-to-day surveillance of the securities markets, this provision has precluded the CFTC and the Commission from developing an effective program for sharing surveillance information. 1/ The proposed legislation would amend the Commodity Exchange Act to authorize the CFTC to communicate directly to any securities self-regulatory organization the full facts concerning any transaction or market operation if necessary or appropriate to effectuate the purposes of that Act. This provision, if

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1/ In this regard, the staffs of the Commission and the CFTC already have held discussions to develop an effective inter-market surveillance program with respect to GNMA futures and GNMA options and have concluded that, until information can be made available by the CFTC or the futures exchanges directly to the securities self-regulatory organizations, an effective cooperative surveillance program probably cannot be developed.

adopted, would permit an exchange of surveillance information necessary to enable the CFTC, the Commission and self-regulatory organizations to detect and prevent attempts at inter-market manipulation involving the futures, options and underlying securities markets.

B. Regulatory disparities

The Commission in the past has commented on several proposals before the CFTC to trade futures on stock indices. 2/ Many of the Commission's previous comments have reflected concerns over disparities between CFTC regulation of stock index futures and Commission regulation of trading in the individual securities that comprise those indices, and options on those securities. To the extent that futures are traded only on broad-based indices, these concerns are lessened. The Commission believes there is little chance that

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2/ See e.g., testimony of Ralph C. Ferrara, General Counsel of the Commission, before the CFTC on the Application of the Kansas City Board of Trade for Designation as a Contract Market in Transactions for Future Delivery Based Upon the Dow Jones 30 Industrial Stock Average Index, October 28, 1978; letter from Irving Pollack, SEC Commissioner, to James M. Stone, Chairman of the CFTC, dated February 19, 1980 (on the Kansas City Board of Trade Value Line Index futures proposal); letter from Ralph C. Ferrara to John L. Manley, Director, Division of Trading and Markets, CFTC, dated June 4, 1981 (on the Chicago Mercantile Exchange Standard & Poor's 500 Stock Price Index futures proposal).

Most recently, the Commission last month commented on the Kansas City Board of Trade's proposed futures contract on the Value Line Index. Letter from Douglas Scarff, Director, Division of Market Regulation, SEC, to James A. Culver, Director, Division of Economics and Education, CFTC, dated February 9, 1982.

individual investors will have difficulty in distinguishing between broad-based stock index futures and individual stocks or stock options, or in understanding that distinct regulatory structures and protections are applicable to each.

At the same time, the implementation of futures trading on GNMAs, Treasury securities, certificates of deposit, foreign currency and stock indices -- and soon options on some of those futures -- under the auspices of the CFTC, combined with the prospect of options trading on each of those instruments under the Commission's oversight, has made it increasingly clear that the CFTC and the Commission are likely to be regulating very closely-related markets pursuant to separate regulatory structures. As industry participants, academicians, and persons at both agencies have recognized, futures and options on the same instruments can serve many of the same functions and likely would compete as financial risk management devices. Nevertheless, they are subject to different regulatory schemes.

One area in which the respective regulatory schemes differ markedly is in the establishment of margin. Margin on securities and securities options is established by, and under the oversight of, the Federal Reserve Board and the Commission. In setting margin levels for options, the margin requirements for the underlying securities have been taken into account. By contrast, the CFTC currently lacks any direct authority over margins under the Commodity Exchange

Act. While the Federal Reserve Board has asserted that it has authority to establish margin for futures on securities indices, it has not yet exercised that authority. Although the Kansas City Board of Trade increased its margin requirements in response to Federal Reserve Board concerns, it should be noted that other commodities exchanges that have submitted stock index futures proposals to the CFTC have not set forth any margin requirements. The Commission believes that financial instruments which serve similar economic needs should be subject to parallel margin requirements.

Another regulatory disparity which the Commission has noted is that, unlike the rules that govern securities trading, 3/ there are no suitability requirements with respect to futures on securities. For commodity options, the CFTC has attempted to address this concern by developing a rule under which the amount of disclosure that a futures commission merchant must provide to a customer in opening a commodity options account is dependent on the personal circumstances of the customer. This rule is related to the opening of account rules applicable for securities options trading, in which broker-dealers must seek to obtain and

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3/ In general, the options suitability rules of the securities self-regulatory organizations prohibit broker-dealers from recommending any options transaction unless they have reasonable grounds to believe that the entire recommended transaction is not unsuitable for the customer.

verify certain specified categories of information before approving an account for options trading. 4/

There are other areas, including supervision and testing requirements, disclosure, and rules governing advertising, discretionary accounts and conflicts of interest, in which the Commission and the securities self-regulatory organizations have established customer protection standards and requirements that differ from those applicable to futures trading.

C. Fair Competition

Finally, financial instruments should compete on the basis of relative economic advantages and the quality and efficiency of the markets and services they provide, not on the basis of differences in regulatory requirements. For example, investors should determine whether to trade in futures or options on stock indices based on their investment needs and their evaluation of the relative risks of those instruments, not on the basis of different levels of margin requirements. Similarly, brokers should decide whether to recommend futures or options transactions based on an evaluation of an investor's needs and interests, not because of differences in applicable disclosure or customer protection requirements. Firms should not be dissuaded from entering

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4/ In this regard, even if a customer's account has been approved for options trading generally, exchange rules require that there must be a separate account approval before that customer may trade a new options product, such as a GNMA or Treasury option.

one market, as opposed to another, because of differences in the applicable supervision, qualification, reporting, or other requirements.

III. CONCLUSION

The accord reached by the Commission and the CFTC relating to jurisdiction over futures and options on financial instruments was prompted by a desire for resolution of statutory ambiguities that have hampered each agency in exercising its responsibilities. The draft legislation developed to implement the accord will resolve those ambiguities in a manner consistent with the concerns of both agencies.

Moreover, as a result of the accord and the proposed legislation, substantial progress has been made in resolving the surveillance and manipulation concerns related to the development of competing futures and options on financial instruments. While some regulatory disparities raise concerns that merit the continuing attention of the CFTC and the Commission, these matters have in the past been addressed at the agency and administrative level. The Commission, therefore, does not believe that these issues should impede implementation of the accord.

Senator D'Amato. Thank you very much, Mr. Chairman.

As I said in my opening remarks, I think that you and your counterpart, Chairman Johnson, should be commended for working to reach an agreement that substantially resolves most of the current jurisdictional questions facing your two agencies.

But some observers have argued that the jurisdictional agreement is flawed because it may result in the trading of similar products on both the securities exchanges and the boards of trade, subject to different regulatory schemes.

It's also said that this might lead to some investor confusion about any legal distinctions between these products which may exist.

Would you care to respond to these views for the record?

Mr. Shad. While options and futures can sometimes be used to achieve similar purposes there are important differences between them and I think investors will be able to tell the difference. There's been long established structural precedent. Options on stocks are traded on exchanges and futures are traded on boards of trade, so I think in terms of confusion—that distinction would be in the accord as well. Futures including futures on stock indices, will continue to be traded, on the boards of trade and options on GNMA's or Treasury bonds under the SEC jurisdiction will be traded on the exchanges. Each has long established procedural and surveillance methods and I don't think that it should result in significant confusion.

Senator D'Amato. As you explained in your testimony, Mr. Shad, the enactment of the agreement will resolve many of the pressing issues facing the market today. For example, the clarification of jurisdiction will enable trading to begin in new derivative instruments for hedging market risk or interest rate risk. At the same time, safeguards will be assured to protect the integrity of the market for the underlying securities.

FUTURE DEMAND FOR NEW PRODUCTS

Clearly, in many areas the jurisdictional agreement will bring needed certainty to the nation's markets. However, there are some issues which this agreement does not address, such as the matter of futures contracts on corporate or municipal securities. In addition, demand may arise in the future for new types of products which would not be governed by this agreement.

Now, looking down the road, do you see any problems which might arise as further innovations are developed? Will the Congress find it necesssary, do you think, to revisit this area in the near future? Will this be an ongoing process?

Mr. Shad. Well, it is true that the markets have been very innovative in attempting to respond to changing economic conditions. These new instruments and financial futures on Treasuries or GNMA's do take on an added importance during a period such as we are in now where we have very significant fluctuations in interest rates, much more so than say, 10 years ago.

I'm sure the future will result in other new problems arising and solutions being proposed. I do believe that the accord addresses the immediate ambiguities and problems and anticipates some new products such as options on foreign currencies, certificates of deposit and other new products, as well as Treasury bills and notes and bonds.

So I believe that it anticipates those that are in the near-term prospect and, yes, I do think that, as times change and new problems arise, and the economy changes, that there will be new products proposed to facilitate the shifting of risks through hedging. There is the likelihood that at some time in the future we will be addressing those new questions and, if they do not fall within the accord, it would be necessary to come back to Congress.

Senator D'AMATO. I'd like to preface my next question by noting that there appears to be a consensus developing both in the private sector, and within the Congress and the administration, that this agreement represents a very important step forward in clarifying the relationship between the SEC and CFTC. Still, some people have raised questions about the legitimate economic function of some of the new instruments covered by this agreement.

For example, questions have been raised about stock index option and futures. Would you care to comment with respect to the legitimacy, and the purpose and use of these instruments? What type of investors do you anticipate will use these new instruments and for what purposes?

Mr. SHAD. The broad-based stock indices, I believe, will afford institutional investors, professional money managers, and others to hedge the risk of general market fluctuations with a view to their performance being based more on their own individual stock selection and less on market fluctuations.

I think that the extent to which the futures on indices will be used, like so many other things, will be a product of the cost. It will depend in part on the levels at which the market reaches equilibrium and the execution costs. The execution costs are very modest, incidentally. The desirable aspect of these type of instruments, of futures, is that whoever suffers a loss, the other side of the transaction enjoys a gain. That is not true in some of the more speculative penny stocks, for instance, in initial public offerings, where the public provides a large portion of the money but receives a small portion of the equity and, as a consequence, the public doesn't always offset gains against losses.

Here, that will be the case. There will be, undoubtedly, professionals who will speculate. There will be individuals, I'm sure, who will speculate. Speculation does add to the breadth and liquidity of the market and it's a form of high risk assumption for above average gain.

SEVENTH CIRCUIT DECISION

Senator D'AMATO. Mr. Chairman, in your testimony you mentioned the seventh circuit decision that just came down. I wonder whether you would comment on what you feel is the significance of that case and what consequences it would have if the jurisdictional agreement is not enacted.

Mr. SHAD. We view it very, very seriously. Not only does it hold that GNMA, government mortgage passthroughs, are a commodity and outside of the jurisdictional authority of the SEC, it raises therefore, the same issue concerning Treasury obligations. We have also authorized options on Treasury bills, notes and bonds, and we are also involved in litigation in the same court on that question. And I would say that the breadth of the decision is such that it would call that into question even though both the Treasury and the Federal Reserve and others commented favorably during our comment period on the utility of those options.

But the same basic principles could be extended even more broadly and could relate to options on all so-called intangibles, including stocks and bonds. So that we view it very seriously and consider this legislation essential, and I'm pleased that the Chairman of the CFTC, Phil Johnson, joins with the Commission in that regard, even though the holding of the case is that this is an area of the CFTC's jurisdiction.

Senator D'AMATO. Well, I had an opportunity to speak to Chairman Johnson following the issuance of the seventh circuit's decision, and he told me in no uncertain terms that he believes the agreement is a good one, that it was moving in the right direction prior to the seventh circuit decision and that it remains valid today. Accordingly, he continues to support the implementation of the agreement by way of this legislation.

Thank you for your appearance here today, Chairman Shad. If you have any further remarks at this time, or if you want to submit any additional comments at a later point, we would be delighted to include them in the record.

If not, we'll stand in recess until Chairman Johnson arrives. He has been attending a markup at the House Agriculture Committee, and has also been requested, after he testifies here, to attend a markup at the Senate Agriculture Committee. I believe he'll be here at 10 o'clock. So we'll recess until 10 o'clock. Thank you very much.

Mr. SHAD. Thank you, sir.

[Recess.]

Senator D'AMATO. The subcommittee will come to order. Our second witness is Philip Johnson, Chairman of the CFTC. Chairman Johnson, I know that you have a hectic schedule today. I understand you have just come from the Agriculture Committee on the House side. I think you will also be attending a markup at the Agriculture Committee on the Senate side following your testimony here.

Mr. JOHNSON. At the moment, Mr. Chairman, the Agriculture Committee is marking up the CFTC reauthorization bill and they've asked me to sit in for that.

Senator D'AMATO. Let me indicate to you that Chairman Shad has just concluded his testimony, and that I noted that you and I have discussed the jurisdictional agreement and S. 2260, the bill which Senator Lugar and I introduced to implement it. I have commended both you and Chairman Shad for making historic efforts in bringing the two agencies together to work out jurisdictional disputes, rather than let them languish in the courts and create market instability. I commend both Chairman Shad and yourself for the leadership you have demonstrated.

I'm looking forward to your testimony, after which I hope you will address yourself to several questions for the record.

STATEMENT OF PHILIP McB. JOHNSON, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. JOHNSON. Well, thank you very much, Mr. Chairman.

First of all, let me thank you for your courtesy and patience in allowing this hearing to proceed as it has. It's been a great help to me personally and I'm very grateful.

Mr. Chairman and members of the subcommittee, on March 16, 1981, while Chairman Shad and I were both awaiting completion of the Presidential appointment and confirmation process, I wrote to John suggesting that, if all went well, we should meet after assuming our respective posts and discuss the issues that had divided the CFTC and the SEC for all too many years. The biggest issue, of course, was where one agency's jurisdiction stopped and the other's began. As that controversy grew older and older, the combatants turned to the courts and to the Congress for allies. The objective, it seemed, was either total victory or unconditional surrender for one side or the other. Members of the Congress, Senators and even judges wondered aloud why two Federal agencies, with far more important things to do, seemed so preoccupied by an issue that could be resolved amicably if only a mutual commitment were made to do so.

Shortly after I joined the CFTC in June of last year, Chairman Shad and I began a series of meetings to identify the issues that separated our two agencies. We were assisted in that process by able and dedicated staff from both agencies. While our ultimate aim was to reach an accord on jurisdictional issues, Chairman Shad and I also wished to signal a more basic change in the relationship between the CFTC and the SEC. Therefore, as the discussions progressed, we decided to join together—for the first time in history—in a lawsuit in Utah involving suspected violations of the statutes of both agencies. That action was very successful and it also demonstrated the combined power of the two agencies, working together, to provide effective public protection.

JURISDICTIONAL PROPOSALS

By December of 1981, the CFTC and the SEC had resolved a number of jurisdictional issues and, after endorsement by both agencies as well as briefings for the leadership of congressional oversight committees, the accord was announced. The terms of the accord were set forth as legislative proposals, now contained in S. 2109 and S. 2260. Both the CFTC and the SEC unequivocally urge enactment of those proposals.

The need for these amendments is now more acute than ever. Last week, the court of appeals for the seventh circuit, in a case challenging the SEC's authority to approve and to regulate options on Government securities at the Chicago Board Options Exchange, held that the SEC's present statutory authority do not reach those types of options, and that only the CFTC can perform those functions.

S. 2109 would amend the Commodity Exchange Act to preclude the CFTC from approving or regulating any exchange options directly on securities, including Government obligations. And S. 2260 would specify that the SEC has that authority under its own statutes. These proposals, if enacted, would effectively overturn the decision of the court of appeals, and would establish the jurisdictional lines agreed to by the CFTC and the SEC.

Other features of the jurisdictional proposal give the SEC an unusually active role in the CFTC's consideration of stock index futures proposals, including a right to be heard and to appeal a disputed decision to the courts. A moratorium would be placed on futures contracts in individual corporate or municipal securities until the two agencies can review that issue further and present their recommendations to the Congress. Options on foreign currencies could be approved by the SEC if sought by a national securities exchange, while the CFTC would oversee other foreign currency options. Market information would be shared by the CFTC with both the SEC and with securities self-regulatory organizations, to aid in surveillance work. And the SEC would oversee the capital formation stage of publicly offered commodity pools, while the CFTC's extensive regulatory requirements would govern the operations of commodity pools after their formation.

Aside from the pending legislative proposals, the CFTC has taken steps to develop a closer relationship with the SEC, and with other Federal regulators, when dealing with futures contracts of interest to them. In addition to the interagency coordination now required by our act, the CFTC has recently extended to the SEC, as well as to the Federal Reserve Board and the Treasury Department, a standing invitation to attend the CFTC's routine, usually weekly, market surveillance meetings whenever a futures contract of interest to them is to be discussed. In addition, a special monitoring system for stock index futures has been created between the CFTC and the Fed, in order to provide useful information to both agencies as that contract develops. All of these steps, we believe, mark the beginning of a new era of cooperation, but without impinging upon the roles assigned by law to any agency.

An ancillary issue that has been raised in connection with the CFTC/SEC accord, and on which Chairman Shad and I have agreed to conduct further discussions, is whether a regulatory disparity exists between the frameworks applied to securities trading and commodities trading. Last week, Mr. Chairman, I provided your staff with some personal observations on that question. I noted the many similarities that exist between the two regulatory programs, as well as some of the differences. I would ask, Mr. Chairman, that that document be made a part of the record of these hearings.

Senator D'AMATO. Without objection, so ordered.

[The copy of the document referred to is printed at the conclusion of Mr. Johnson's testimony at page 56.]

Mr. JOHNSON. Thank you.

In the interest of time, I will address only two regulatory issues here: the differing systems of margining for stocks and commodities; and the customer suitability question.

MARGINS

While the term "margin" is used in futures trading, it bears no resemblance to stock margins. Futures margins are good faith deposits made by both parties, seller as well as buyer, on futures contracts to pay any market losses that occur while the contracts are held. This deposit is not a downpayment since a futures trader has no ownership interest at all in the underlying item. He acquires nothing more, as a practical matter, than the right to receive profits or to suffer losses from movements in market prices. Fewer than 5 percent of all futures contracts ever result in an actual sale. Almost all futures are extinguished in the market without a sale ever occurring.

Upon acquiring a futures contract, traders must deposit about 5 percent of the underlying item's value with the broker. This is required even though the trader has bought nothing, and has not yet suffered any market loss. If losses do occur, more deposits will be required to cover those losses, so that the trader never has any outstanding debt in the market. These deposits can be very substantial during adverse market movements, as the following illustration shows.

Had a public trader in gold futures taken a "long"—that is, a buying—position in the market of 25 contracts in April 1981, calling for delivery in April of this year, his initial deposit or margin would have been at least $75,000. As the price of gold fell, he would have been required to deposit more funds to cover his losses. By mid-May 1981, he would have had to deposit another $116,000. By July, an additional $166,000 would have been required. If the trader had held his contracts into February of this year, total deposits of about $500,000 would have been paid to his broker. These deposits covered the trader's market losses as they occurred and, despite the massive payments, the trader still did not own a single ounce of gold. This system of "pay as you go" is what commodity margining is all about.

I should note as well that commodity brokers are generally prohibited by exchange rules from lending money to customers to margin trades. In fact, the broker has the right to liquidate a customer's account if losses are not promptly paid.

Stock margining is drastically different. There, the investor actually buys the stock. But he need not pay the full purchase price. Instead, he can borrow up to half the price, usually from his broker. In other words, a stock investor can actually own securities while in debt for about half of the stock's value. This is impossible in futures trading, where no debt whatsoever is allowed.

When this important distinction between commodity and security margins is understood, it is easier to compare the two systems. Thus, if the initial deposit on a futures contract is 5 percent of the underlying value, this is 5 percent more than the trader owes on his holdings since he does not yet own the underlying item, nor does he owe a single penny to anyone. But, if the initial margin on a stock purchase is 50 percent of the stock's value, it is 50 percent less than the investor owes on the securities that he already owns. And, recall that 5 percent is only the initial deposit for a futures contract. The real cost can be many times greater, as the gold trader in the earlier illustration found out, even though he had not yet acquired any gold. It would certainly appear that commodity deposits or margins are substantially more onerous than stock margins, since no debt is permitted in futures trading while as much as 50 percent debt is allowed for stock purchases.

The greater burdens of commodity margins are one reason why relatively few people trade in the futures markets. It has been estimated that as few as 100,000 public speculators exist in the commodity markets, as compared with over 30 million Americans in the stock market. This indicates that only one out of every 300 stockholders ventures into the futures markets. And those who do trade futures appear to be more affluent than the typical stock investor, which brings me to the subject of customer suitability.

SUITABILITY

As you know, customer suitability rules exist in the securities industry. Typically, these rules require a broker to be conversant with an investor's circumstances and investment objectives before making trading recommendations to him. These rules frequently do not apply if the investor makes his own trading decisions.

There are compelling reasons to have suitability rules in securities trading. First, the 30-million people in the stock market constitute about 20 percent of the entire adult population of the United States. This huge population of stockholders suggests that investors represent virtually every walk of life and every social and economic strata of our society. Second, stocks vary dramatically in risk, from blue chips to special situations and even hot or penny stocks. Choosing among so diverse a group of stocks requires care and attention to investor needs. Third, stocks are often marketed as part of long-range financial planning, such as for retirement, and therefore are relied upon heavily for personal security. All of these factors combine to demonstrate a need for customer suitability rules in stock trading.

But none of these features apply to futures trading. Less than 1 percent of the stockholder population is in the commodity markets, and those who do participate appear to be unusually affluent and sophisticated. A recent survey by a leading trade publication shows that, of those responding, the average annual income was over $60,000, and the average net worth approached $450,000. One major brokerage firm, handling an estimated one-third of all public commodity traders, requires an annual income of at least $30,000 and, more importantly, a net worth of at least $100,000, excluding home equity and insurance. The survey showed that 75 percent of all respondents have college degrees, and 25 percent have postgraduate degrees. Most respondents either owned their own businesses, were corporate executives or licensed professionals, or were already associated with the commodity industry as brokers, analysts or researchers.

In addition, there is no such thing as conservative futures trading. The level of risk in futures trading is potentially high for all commodities. And, futures are neither marketed nor acquired for long-term financial purposes. Rather, they are readily recognized as short-term, high risk instruments, with onerous margin requirements and the remote yet real possibility of delivery of an unwanted item. All of these features help to account for the fact that about 299 out of every 300 stockholders do not trade futures.

Finally, the survey mentioned earlier indicated that only 8 percent of the respondents rely on broker recommendations when making trading decisions in the futures market.

These features of futures traders and futures markets suggest that a suitability rule would contribute little to the process. The affluence and sophistication of the traders, the well-known risks involved, and the low reliance on broker recommendations, support that conclusion. Moreover, it seems clear that an even more effective suitability system already exists, which is responsible for the fact that less than 1 percent of all stockholders, all of whom are presumably suitable for stocks, have entered the futures markets. The very nature of futures trading achieves this result, silently but effectively.

Mr. Chairman, I want to thank you for this opportunity to appear before the subcommittee. I will reiterate here the commitment of the CFTC to the jurisdictional proposals set forth in S. 2109 and S. 2260, and urge congressional support for them. Thank you.

Senator D'AMATO. Thank you, Mr. Chairman, for your testimony. I'm going to try to limit my questions because I think you covered very well many of the points that I wanted to raise. But I would like you to comment on the destructive effects on the market which you believe may occur if the proposed legislation is not enacted.

POSSIBLE MARKET DISRUPTION

Mr. JOHNSON. Mr. Chairman, it's very likely that if the legislation is not enacted, particularly in the face of the decision of the Court of Appeals in Chicago last week, that there could be market disruption.

The SEC has traditionally regulated options trading beginning with the Chicago Board Options Exchange in the early 1970's. It has a regulatory program in place for options on securities. The decision of the seventh circuit, in my judgment, raises serious doubt as to whether any of that regulatory structure or expertise can be brought to bear at this point.

The legislation that has been proposed would resolve that issue and restore the relationship and the regulatory role of the SEC as many had understood it to be prior to the decision.

Senator D'AMATO. Many people have raised questions about the new instruments and their economic purpose. Indeed some have suggested that they will lead to unduly speculative, even dangerous markets. I think you addressed in your testimony the affluence and sophistication of investors in the futures markets, as well as the limited number of people who are investors or potential investors.

Don't you feel, though, as more people learn about the futures markets and these new instruments, that these markets will attract a greater number of participants?

Mr. JOHNSON. I have no reason to assume that the newer instruments are going to appeal to the public any more really than the old ones. I understand there has been a hypothesis advanced that many, many people in the United States understand stocks and that, because of that, there may be a greater interest among the general public to trade in stock index futures.

My personal view, Mr. Chairman, is that having recounted to you what happened to the gold trader, this could happen just as easily to the stock investor, that the disincentives for futures trading are no less and I don't anticipate that the general public is likely to enter this area with any more glee than they've entered into the others.

I might mention as well that in the stock index area preliminary statistics indicate that the largest traders in the market and a very substantial percentage of all the trading is being done by securities houses, specialist firms, block positioners, and people of that nature, not as a substitute to the normal securities business but as a price insuring hedge.

Senator D'AMATO. Before we conclude, let me once again express my sincere appreciation for your determination to pursue enactment of this agreement and to lend your total support to it. As you advised me, in view of the seventh circuit's case, you felt it was even more important that we come to a speedy resolve of this matter. This indicates to me a very special quality which many Government officials are lacking. I want to publicly commend you for that sense of perspective and that purposefulness, which transcends the parochial interest agencies may have in expanding their jurisdiction or their authority. That is a very welcome quality that I have not perceived in all of our agencies in the Federal bureaucracy.

So, Chairman Johnson, I know that you and Chairman Shad are going to continue working together cooperatively to deal with the remaining unresolved issues and any other issues that may arise in our evolving financial investment community. I look forward to working with you in that cooperative effort.

Mr. JOHNSON. Well, thank you very much, Mr. Chairman. Again, I thank you for your kindness this morning in accommodating my schedule.

Senator D'AMATO. The subcommittee is adjourned.

[Whereupon at 10:25 a.m, the hearing was adjourned.]

[Additional material received for the record follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

March 31, 1982

Dear Mr. Chairman:

I recently sent a letter (attached) to Senator Helms indicating the Administration's position on the reauthorization of the Commodity Futures Trading Commission. The Administration recommended in that letter that the resolution of the SEC/CFTC jurisdictional dispute approved by Chairmen Shad and Johnson be incorporated in the CFTC reauthorization bill.

This letter endorses changes in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisors Act of 1940 to incorporate the resolution of the jurisdictional dispute in these statutes, thus complementing the changes recommended in the CFTC reauthorization bill. I understand this can be accomplished by enactment of S. 2260.

I respectfully request that this letter be included in the appropriate records of the hearings on this matter being conducted by the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs. Thank you for your cooperation.

Sincerely,

Roger W. Mehle

Roger W. Mehle

The Honorable
Alfonse M. D'Amato, Chairman
Subcommittee on Securities
United States Senate
Washington, DC 20510

Attachment

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

March 12, 1982

Dear Mr. Chairman:

The purpose of this letter is to express the Administration's position on the reauthorization of the Commodity Futures Trading Commission (CFTC).

After careful consideration at the sub-Cabinet and Cabinet levels, the Administration recommends:

1. Reauthorizing the CFTC for a fixed period of at least four years;
2. Offsetting the costs of the CFTC through user fees without discouraging membership in the National Futures Association;
3. Retaining the CFTC's exclusive regulatory jurisdiction over national exchange trading and pool operators;
4. Authorizing the CFTC to share information with State governmental authorities in connection with legal actions or investigations conducted by States; and
5. Incorporating the resolution of the SEC/CFTC jurisdictional dispute approved by Chairmen Shad and Johnson in the CFTC reauthorization bill.

These recommendations are consistent with the provisions of S. 2109 and H.R. 5447 as introduced at the request of the Chairman of the Commodity Futures Trading Commission.

I respectfully request that a copy of this letter be included in the appropriate records of the CFTC reauthorization hearings recently conducted by the Agriculture Committee's Subcommittee on Agricultural Research and General Legislation. This letter is also being transmitted to the Chairman and ranking minority member of the Subcommittee. Thank you for your cooperation on this matter.

Sincerely,

Roger W. Mehle

Roger W. Mehle

The Honorable
Jesse A. Helms, Chairman
Committee on Agriculture, Nutrition
and Forestry
United States Senate
Washington, DC 20510

SIMILARITIES AND DIFFERENCES BETWEEN SECURITIES REGULATION AND COMMODITIES REGULATION

When futures contracts in Midwestern grain began in Chicago in the second half of the 19th century, only a handful of farmers, brokers and traders knew what that market was about. Only a modest amount of improvement has occurred in the public's knowledge of futures trading since then. Futures trading, even today, is largely confined to businesses and to relatively affluent, well-educated speculators. The "average guy" still does not have direct contact with these markets to any significant degree, and still does not understand them. This paper has been prepared as a brief overview of the futures markets of today: what they are, what they do, and what they mean to the American economy. Of special interest to the Subcommittee will be the discussion of the many differences between the futures markets and the stock exchanges.

What is a "futures contract"?

First of all, it is a contract rather than an actual sale. To "own" a futures contract is a far cry from owning the underlying item. All that has occurred is that two parties have agreed that an actual sale of the item may take place at a specified time in the future. We say "may" take place because it need not and, in fact, rarely does. Over 95% of all futures contracts do not result in an actual sale. Instead, the parties engage in "offsetting" trades in the futures market itself, thus avoiding a real sale of the underlying item. (The "offset" procedure is described in the attached Appendix.)

Compare a stock transaction. There, a real asset--a security--passes from the seller to the buyer. The buyer takes title to the stock and, typically, the issuing corporation or its transfer agent records the buyer as the new owner. The buyer can list the stock as an asset on his financial statement and can use the stock as collateral for loans. None of this occurs when a person "buys" a futures contract because nothing has yet been bought.

What is the purpose of a futures contract?

If futures contracts are not normally used to actually buy and sell the underlying item, then what is their purpose? They are intended to be an adjunct or aid to those who actually buy or sell the underlying item in normal commercial channels. Frequently, futures contracts are likened to "price insurance policies" that protect a businessperson from the risk of having to pay higher prices to suppliers for what he buys, or having to accept lower prices from customers for what he sells.

Here is how the system works. The product in which banks deal is money. They borrow it, and they lend it. Interest rates determine what the bank must pay for new money, and what the bank can charge on the loans that it makes. Since interest rates fluctuate, the bank is at risk that the cost of new money may rise, or that the return on loans may fall. Changes in interest rates, therefore, can spell either profit or loss for the bank.

Financial futures, such as Treasury Bond futures, react to changing interest rates. Thus, there are Treasury Bond futures that rise in value if interest rates increase, and there are other Treasury Bond futures that rise in value if interest rates fall, depending on whether the bank is on the "long" or "short" side of the market. (The terms "long" and "short" are explained in the Appendix.)

A bank with interest rate risk can use Treasury Bond futures (or other financial futures such as in T-Bills) to generate trading profits in the futures market when its cost of borrowing is rising, or when its revenues from loans are declining. Those profits cushion the expense or loss incurred by the bank as it conducts its regular business. Note that the bank has not altered its normal banking practices. It still borrows new money from its regular sources, and it still loans money to its regular customers. The futures contracts are simply a separate way to even out (i.e., to "insure" against) the effects of interest rate fluctuations associated with the bank's operations.

In commodity parlance, the use of futures contracts in this way is called "hedging." The benefits of hedging are realized without having to actually make a purchase or sale of the Treasury Bond. The bank enters the futures market to hedge against interest rate risk and later exits the market through the offset process, receiving profits from the trading that compensate for losses incurred in the banking operation.

Treasury Bond futures and other financial futures are used in this fashion by approximately 200 banks, including 19 of the nation's top 30 banks.

This hedging function of futures contracts is not limited to banks and financial futures, of course. For over a century, agribusiness has used futures hedging to protect against price risks in its regular commercial activities. And, more recently, futures hedging has been used in other industries as well.

What items are traded under futures contracts?

At the present time, 47 different items have futures contracts. In addition to financial instruments, futures contracts exist in grains, livestock, vegetable oils, precious and industrial metals, construction materials, fibers, and energy products.

Do the contracts differ widely in their design?

No. None of the futures contracts is intended for the actual buying or selling of the underlying item. Instead, all futures contracts are designed to achieve the same objective--price protection or price discovery--no matter what the underlying item is. Thus, while each futures contract will attempt to address the particular type of price risk involved (e.g., interest rates, merchandising margins, etc.), they are all remarkably similar in basic design. Like insurance policies, the contracts have many common features irrespective of the industry that they serve.

What economic events affect the price of futures contracts?

Generally, futures contracts respond to broad economic developments, such as construction activity, money market trends or agricultural trade.

International as well as domestic economic and political developments are also a factor. For example, futures prices for some agricultural products are currently depressed as the result of abundant domestic production and unstable international trade conditions. And financial futures contracts respond generally to the money supply, inflation and the general health of the domestic and world economies.

The prices of individual securities, on the other hand, are far more immediately affected by the fortunes of a particular company. As part owner of a particular corporation, the stockholder is especially concerned about how it fares, and the value of his securities will reflect the current assessment of that company.

What information is needed to trade futures contracts?

With respect to futures contracts, the vast majority of pertinent information is publicly available through Government sources or other means. Crop planting statistics published by USDA, money supply data from the Treasury, inflation information from the Department of Labor, and import/export reports from the Commerce Department, are only some of the data publicly available that influence futures trading decisions. Through news media and subscription services, other economic information can be obtained.

In securities markets, on the other hand, the most pertinent information may be about a particular company in which the investor owns stock. This often includes private data that the corporation may or may not make public, but which could have a market effect if it were known. An undisclosed pending merger, or a not-yet-released report showing heavy losses, or a secret oil "find," could cause the stock of the company to rise or fall dramatically. This type of private information is frequently labeled "insider" information. From time to time, company officials or "tippees" may use this valuable but still secret information to make large profits by buying stock before favorable news becomes public, or to sell their stock before bad news causes a drop in prices. This use of "insider" corporate information is illegal under the Federal securities laws.

What types of people trade futures contracts?

An exact profile of futures traders has never been made. However, a fair description can be given from available information.

A. How many? The precise number of traders in the futures markets is not known. But they fall generally into three categories: (1) Professional speculators, such as members of the futures exchanges; (2) Commercial hedgers, such as banks, grain companies, and metal dealers; and (3) Avocational public speculators. As much as 75% of all futures trading is done by the first two cateogories--professionals and hedgers--who are generally sophisticated and well-capitalized.

Avocational public speculators appear to account for no more than 25% of all futures trading. One estimate of their numbers is 100,000 in the market at any given time.

B. What do they look like? Professionals and hedgers are, as indicated above, generally knowledgeable and financially strong. They use the futures market as a business activity.

Avocational public speculators appear also to be relatively affluent. Last year, a leading trade publication in the futures industry conducted a random survey of its subscribers. It found that nearly 80% of the respondents were owners of businesses, corporate executives, professionals (such as doctors, lawyers and accountants), or were already associated with the industry as brokers, analysts or researchers. Two-thirds of the respondents were college graduates, and 25% had post-graduate degrees. Their average income exceeded $60,000 a year, and their average net worth was nearly $450,000.

That survey, of course, may have included persons that would fall into one or both of the first two categories (professional traders and hedgers), and who are not avocational public speculators. On the other hand, the profile of the avocational public speculator as a rather affluent person comports with the account opening policy of a major brokerage firm handling an estimated one-third of all public futures traders. In that firm, a prospective futures customer must have a net worth, exclusive of home and insurance, of at least $100,000, an annual income of at least $30,000, and must make a minimum deposit of at least $10,000.

C. Comparing the stock investor. As indicated earlier, the number of avocational public speculators in the futures markets may be as low as 100,000. Meanwhile, there are known to be about 30,000,000 identifiable stockholders in the American securities markets. Thus, the public futures traders may account for only three-tenths of one percent (.003) of the stockholder population, or 1 in every 300 securities investors. Considering that 30 million stockholders is equal to 20% of the entire adult population in the United States, it seems fair to assume that securities investors include virtually every social and economic strata in our society, and would, in general, be less affluent and less sophisticated than public futures traders.

Do avocational public speculators account for most trading?

No. As noted earlier, these public traders represent only about 25% of all trading. The rest is done by professionals and hedgers.

In the futures market, well-capitalized traders tend to be the largest consistent participants. Under CFTC rules, substantial market positions of traders must be reported daily to the Commission. In Gold futures, for instance, daily reports must be filed for traders holding 100 or more contracts. To achieve holdings of even 100 Gold contracts, a speculator would have to deposit at least $200,000 with his broker. Even so, these large traders held 73% of the Gold contracts in 1981. A similar situation existed in Treasury Bond and GNMA contracts during 1981. In those two contracts, the minimum reporting level was also 100 contracts, which would mean at least a $200,000 deposit by a public speculator with his broker. Yet, large traders accounted for over 60% of all Treasury Bond holdings, and about 72% of all GNMA positions. In a newer financial futures contract--Domestic bank certificates of deposit--where a deposit of $50,000 would be needed by a speculator to hold the minimum reporting level of 25 contracts, these large traders accounted for over 70% of all holdings in 1981. Large traders in financial futures are typically investment dealers, commercial banks, corporations, industry professionals and funds managers, rather than public speculators.

Does the minor role of avocational public speculators hold true for the new financial futures?

Yes. The previous paragraph shows that the well-capitalized large trader accounts for most futures holdings in the major financial futures contracts.

We see no significant change in trader profile in the Kansas City Board of Trade's new stock index futures contract. While it will be some time before definitive conclusions can be reached (trading only began in late February), preliminary figures provided by the Exchange indicate that 58% of the "long" side of that contract, and 38% of the "short" side, involved commercial accounts. These figures probably do not include a number of professional traders (e.g., members of the Exchange), an additional figure that would have to be known in order to pinpoint the net role of avocational public speculators in the Kansas City contract. Another statistic, provided by a brokerage house specializing in financial futures, showed that 86% of its customer orders for "long" stock index contracts, and 88% of its "short" orders, were for commercial accounts. Thus, it would appear that avocational public speculators are playing a minor role in the stock index contract, just as they do in most other financial futures.

Why aren't more avocational public speculators in these markets?

There is good reason why the stock markets can boast at least 30 million participants, while futures markets have less than 1% of that number. There are certain inherent differences between stock ownership and futures trading. Stock does not expire, while futures contracts do. Once bought, the owner of stock cannot lose more than the purchase price, whereas a futures trader can lose many times his original deposit with the broker. (The financing system for futures is described later.) Once stock is bought, the transaction is completed, but the acquisition of a futures contract does not complete the process. Rather, the holder must either be prepared to offset his contracts in the market prior to the contract's expiration (a 95% probability) or go through the delivery process for the underlying item when the contract matures.

The vast majority of the public, including those who have never been in the futures markets, perceive of futures trading as a short-term, high-risk endeavor. That same public, on the other hand, views securities investing as a more conservative step. Indeed, many stocks are marketed by brokerage firms as appropriate for long-range financial planning, such as for retirement. For instance, funds in individual IRA or Keough Plans are frequently invested in stocks. Corporate pension funds also invest heavily in stock and are the largest holders of NYSE securities. Futures contracts, by their very nature, are not marketed or acquired for such purposes.

Moreover, stocks vary widely in risk. There are "blue chip" securities, "special (short-term) situations," as well as "hot" issues and "penny" stocks. The investor has the choice of becoming an owner of a company ("equity" securities) or a lender (corporate bonds or Government issues). But, in futures trading, all contracts have essentially the same level of potential risk. Depending on economic developments, any futures contract can carry very high price risk.

The level of risk is different even between futures contracts and stock options. The buyer of a stock option has a limited risk, namely, the possible loss of the premium paid for that option. He can lose no more than that. But the buyer of a futures contract can lose very substantial amounts of money if the market moves significantly against him. The futures trader's risk, in other words, is unlimited.

Another factor is the Federal tax treatment of stocks and futures contracts. The long-term capital gains rate for stocks (and stock options) is 20%, while futures contracts are taxed at an average rate of 32%. Futures contracts with a cash settlement system (described in the Appendix), including stock index futures, may be taxed even more heavily, at a 50% rate.

All of these factors contribute to the decision by about 299 out of every 300 stockholders to decline to participate in the futures markets.

What is the financing system for futures trading?

It is radically different from the "margining" system for securities, and considerably more onerous.

Remember that the holder of a futures contract does not own the underlying item, or any part of it. All that he gets is the right to be in the futures market, that is, to enjoy profits if price movements are favorable, and to suffer losses if adverse price changes occur. Futures contracts rarely result in an actual sale of the underlying item. Over 95% of all futures contracts are offset in the market without an actual sale.

Because a futures trader owns nothing when he enters market, his financial interest at that moment is zero. Nevertheless, he must deposit funds with his broker, even though he has not yet incurred any financial obligation. This deposit must be made by potential sellers as well as potential buyers. The reason for requiring both parties to deposit funds is that both may suffer market losses which, as noted earlier, is the only financial obligation that either is likely to incur. If, in fact, market prices do produce losses in the contract, the trader will be required to deposit more funds with his broker to cover those losses, and must do so promptly. Moreover, brokers are not allowed to lend money to customers to cover these losses and, in fact, will liquidate any account that falls into arrears. The objective of this financing system is to require traders to cover all losses as they occur, so that no debt on the contracts will remain outstanding. Indeed, the initial and subsequent deposits are designed to assure that, even after losses are paid, there is still some extra money in the account. One might summarize the system as a strict "pay as you go" policy.

By way of illustration, let's assume that a public trader bought 25 Gold futures contracts in April of 1981, and that those contracts would expire in April of this year. The trader's initial deposit with his broker would have been at least $75,000, although no debt had yet occurred. By mid-May, 1981, the trader would have been required to deposit $116,000 more. By July, an additional $166,000 would have been demanded by his broker. Had the trader continued to hold those Gold contracts, this process would have been repeated many times until, in February 1982, a total of about $500,000 in deposits would have been paid to the broker.

How does the financing system for futures trading differ from stock margining policy?

The system described above is often called "margin" in the futures business, an unfortunate choice of words because it is nothing like the way that stock purchases are "margined." Buying stock "on margin" typically means that an investor can actually own securities (while the futures trader owns nothing) by paying about half the price, with his broker lending the rest to him. The stock is usually left with the broker as collateral for the loan, and can be sold by the broker if loan payments are not made. In other words, stock can be bought on credit and the investor can remain in the stock market even though he is as much as 50% in debt on the securities. This cannot be done in futures trading, where absolutely no debt is ever allowed, and where brokers are prohibited from lending money to traders to cover any part of their debt. When this important distinction is understood, the level of futures deposits can be more accurately compared with stock margins.

Then, is it inaccurate to say that futures contract deposits are less burdensome than stock margins?

Yes. If the initial deposit on a futures contract is roughly 5% of the underlying item's market value, this is 5% more than the trader owes on his holdings. If the initial margin on a stock purchase is 50% of the security's price, it is 50% less than the investor owes on his holdings. And, remember that 5% is only the initial deposit for a futures contract. The real cost can be many times larger than that, as the Gold trader in the earlier illustration found out. One might conclude, with justification, that the financing system for futures trading is substantially more onerous than stock margining policy.

Does the financing system for futures trading make futures contracts more attractive to investors than stocks?

No. While it has been argued that the usual 5% initial deposit required for futures contracts may lure unsophisticated traders into the futures market, or may divert investors from the stock market, the trader profile discussed earlier indicates otherwise. The "pay as you go" system in futures trading, where more and more deposits may be demanded by the broker as losses accrue; the short-term, high-risk nature of futures contracts; and the remote but real possibility of becoming involved in the delivery of an unwanted item, have all combined to limit the futures population to well below 1% of the stockholder population. Thus, initial deposits of roughly 5% on new futures contracts, coupled with repeated demands for more money during adverse market movements, are not attractive to the overwhelming number of potential traders.

And we see no significant change in that attitude with new stock index futures. For instance, a private survey was conducted two years ago in connection with the Kansas City Board of Trade stock index contract. It was sent to certain institutional investors, such as pension consultants, mutual fund managers, commercial banks and insurance companies. Institutions of this nature account for 70% to 80% of the dollar volume on the NYSE. These recipients were asked to identify the most important advantage of the Kansas City proposal. Of 47 respondents, fewer than 1 in 10 said that the initial deposit requirements for that contract (then expected to be 5%, but since raised to 10%) would be the most important advantage of using the contract, while 72% said that portfolio risk reduction ("hedging") would be the greatest advantage.

Should we expect that financial futures will divert capital from the primary and secondary markets in the underlying instruments?

No. There is no evidence that financial futures (or any other futures, for that matter) weaken the primary or secondary markets. They are a "price insurance" tool used in conjunction with actual market activity, not as a direct substitute.

In fact, studies conducted by the Government, as well as by academicians, all reach the same conclusion: Futures do not destabilize the underlying markets. While financial futures contracts are relatively new, and have not undergone the intensive economic analysis heretofore made of other futures, there is little reason to believe that the conclusion will be different for financial futures.

In October of 1981, a representative of the Treasury Department testified in Congress that, while Treasury had been originally concerned about the potential adverse impact of financial futures on the underlying cash market, experience with financial futures has greatly alleviated that concern and that financial futures markets provide important services to the national economy:

> In the past, Treasury was concerned that it would lose flexibility in managing the Nation's debt because market participants would believe that Treasury had an obligation to supply a particular security traded in the futures market. This situation could arise because of an apparent inadequacy of deliverable supply on a particular contract or because of futures markets' expectations that a certain security would be offered. In this connection, the Treasury had been concerned that proliferation of financial futures contracts could result in deliverable supply problems or could result in other problems, such as attempted manipulation or financial troubles to participants, because of a competitive devaluation of self-regulatory standards by the exchanges. Also, there was the concern that if the futures market adversely impacted the cash market for Treasury securities, the Treasury would have greater difficulty in marketing its debt.
>
> These concerns were expressed in the May 1979 Treasury/Federal Reserve Study of Treasury Futures Markets. Experience with these markets since then has to a great extent alleviated these concerns.
>
> . . . Moreover, we believe that the financial futures markets on balance provide important services to the national economy, specifically, the shifting of risk to those willing and able to bear it, price discovery and dissemination, and increased liquidity of the cash market.

While stock index futures are too new to be studied in the same way that other financial futures have been, there is no reason to believe that a different conclusion will be reached ultimately. Stock index futures are precisly that--futures--with all of the same risks and disincentives of other futures contracts that have deterred over 99% of all securities investors from speculating in the futures markets. Early statistics from the Kansas City Board of Trade appear to bear out that conclusion. Roughly 58% of the "long" trading in its stock index futures contract, and 38% of the "short" trading, has been done for commercial accounts. Add to those percentages the presently-unknown trading done by professional speculators, such as Exchange members, and participation in the stock index contract by avocational public traders is likely to be quite low. These early statistics have a special significance because, traditionally, commercial use of new contracts tends to lag behind speculative interest as these firms wait to see if the market will develop liquidity and breadth before entering. Recall, as well, the survey of two years ago (described earlier) in which 72% of the responding institutional investors--the stock market's greatest users--identified portfolio risk reduction (i.e., hedging) as the greatest advantage of stock index futures.

Some say that stock index futures are "pure gambling." Is this a fair characterization?

No, but it is a typical early reaction to nearly all new futures contracts. Farm futures were labeled as "grain gambling" in their early days. Similar characterizations greeted financial futures when they began in the 1970's. Today, agricultural futures are recognized as an important contributor to America's preeminence as food supplier to the world. And, financial futures have been credited with providing a "safe harbor" for institutions buffeted by gyrating interest rates.

Speculation exists in futures markets, of course, as it does in any market, including the stock markets. While the term "speculator" is defined in a variety of ways, it is used in futures trading to mean a person who enters the market in the hope of making a profit from favorable price movements. This is the trader's only motive, unlike a "hedger" who is attempting to protect the price of other commercial sales. Does this definition sound a lot like the description of the typical securities investor? Of course it does. Stock is bought in the vast majority of cases in the hope that market prices will move favorably, and without any commercial objective whatsoever. (Some might rationalize that stockholdings differ in that dividends may be paid, but there is no assurance of that and, even when paid, the rate of return is frequently too small even to offset inflation.) A recent survey reported that nearly 90% of the polled investors identified price appreciation as their reason for buying stock, and only half of those investors gave income as an additional motivation. So, it is necessary to recognize that the futures "speculator" and the stock "investor" have very similar objectives. Except that, as indicated earlier, the futures speculator is usually more affluent.

The speculator in futures trading performs two functions. First, he acts as the "insurance company," taking the price risk that a commercial participant wishes to avoid through hedging. While there are times when different hedgers, one "long" and one "short," may trade with one another, the speculator assures that hedging is possible in the many instances when this does not occur. Second, speculators make a market even if hedgers are not active at a particular time, such as when hedgers have established their trades and are holding them open.

Thus, the presence of speculators in the futures market is necessary to service the needs of hedgers and to assure a continuous, competitive market. But the primary reason--the "economic purpose"--of futures markets is for price hedging and price discovery. This is why the CFTC, unlike the SEC, has special economic standards that must be met before a new futures contract will be authorized to trade, and why a contract with great investor appeal but no hedging or price discovery function will be rejected by the CFTC.

Do the new stock index futures contract meet the "economic purpose" requirement?

The Kansas City Board of Trade contract, approved by the CFTC in February, satisfies that requirement. All other proposals will be reviewed under the same standards.

There are a variety of price risks in securities dealings. For instance, a block positioner who acts as an intermediary between sellers and buyers of substantial blocks of securities is at risk that the securities may decline in value during the period when the block positioner owns them. Such a decline may be caused, for example, by a general downturn in the stock market as a whole. In 1980, block positioners on the NYSE handled over 3.3 billion shares of stock, or almost 30% of the reported transactions on the NYSE. Thus, the risk to block positioners of adverse market developments is enormous. To protect against this risk, a block positioner can acquire "short" stock index futures that will profit from a downturn in the market, thus recouping all or a substantial part of the losses sustained in the block of securities.

Similarly, a specialist is at risk that stocks held "in the book" will suffer adversely from market changes. Here, stock index futures may help to reduce that risk by generating profits if losses in the specialist operation occur.

In addition, an underwriter of new issues bears a similar risk that, having bought the stock from the issuer at one price, it may have to be sold at a lower price or might, in fact, have to be absorbed by the underwriter itself if prices drop significantly. Stock index futures can be used to shield the underwriter against much of that risk through profits on the futures contracts.

A large and diversified portfolio manager can protect his stockholdings in much the same way, with "short" stock index futures that profit if the securities market declines.

Stock index futures can also be used in anticipation of the purchase of stocks. An investment manager anticipating receipt of new funds for investment in the stock market might buy "long" stock index futures that will profit from rises in market prices, thus recouping from the futures markets some of the added cost of purchasing investments at the higher market prices after the new funds arrive.

Stock index futures are designed to "track" broad market trends, rather than to protect a particular stock. Stock options would appear to be a better hedging vehicle where only one or a few stocks need protection, since options on those specific securities would tend to follow the prices of the particular issues more closely than would a broad stock index futures contract. But, even where a single security is involved, stock index futures might be useful in order to "isolate" the stock from general market trends. For instance, an investment manager might select a particular stock in the belief that it will "out-perform" the market as a whole. That belief could be dashed if the stock's actual performance is adversely affected by a general market trend. The stock might not perform as well as expected simply because of overall bearishness in the market. The degree to which that stock falls short of the performance expectation can be offset by stock index futures contracts which profit from the bearish condition of the market and thus shelter the stock from the market's effect. The net return--futures profits and less-than-hoped-for stock performance--may approximate the result actually sought by the investment manager.

What are the differences in the way that the CFTC and the SEC regulate their respective markets?

Let's begin with a discussion of the similarities, rather than the differences. Both the CFTC and the SEC prohibit fraud, deception, and market manipulation. Both agencies monitor the financial strength of the brokerage firms, with very similar requirements. And both require risk disclosure, although under somewhat different procedures discussed later. Industry professionals are subject to registration requirements at both agencies, depending upon whether they deal in securities or commodities.

There are, of course, some notable differences.

A. Economic Purpose. As noted earlier, the CFTC will not authorize trading in an instrument that has only investor appeal. To be eligible for trading, every futures contract must fulfill either a price hedging function or a price discovery purpose for commercial enterprises. The CFTC's review of each new proposal includes an intensive economic analysis to determine if these features exist, and the CFTC has a staff of 104 in the economic analysis area alone.

SEC policy focuses upon "full disclosure." Thus, a security will be cleared for trading if potential investors are given all of the material facts about it. No "economic purpose" is needed, nor reviewed.

B. Customer Funds. Since 1936, the CFTC (and its predecessor) have prohibited a brokerage firm from using even a single penny of funds belonging to customers for any other purpose than to cover those customers' trading obligations. It is a crime for a brokerage firm to apply any of those funds to any other purpose.

Securities brokerage firms are not completely restricted in this fashion.

C. Clearing House Guarantee. Every futures contract entered into is guaranteed by the sponsoring exchange's clearing organization. Thus, neither direct party to the transaction is dependent upon the other party for gains or losses that accrue.

While this traditional futures protection has been engrafted onto stock options regulation, it does not exist in the regular stock markets. (The use of futures regulatory principles in stock options trading is further discussed in the Appendix.)

D. Speculative Position Limits. In futures trading, speculators are limited in the size of their holdings, in order to prevent market domination by large traders. While a comparable restriction has been engrafted onto stock options regulation, it does not exist in the regular stock market.

E. Daily Price Limits. In futures trading, the price of a particular futures contract is not allowed to rise or fall more than a certain amount each day. This is designed, in part, to avoid precipitate price movements over short periods. While a similar limitation has been engrafted onto stock options regulation, it does not exist in the regular stock market.

F. Customer Margins/Deposits. As discussed at length in earlier sections, futures trading prohibits the carrying of any debt by a customer, whereas a securities owner is allowed to carry an unpaid debt of 50% of the purchase price that is already due and owing.

G. Reparations. The CFTC has a unique reparations program in which injured futures customers may file claims with the Commission for damages based upon violations of the Commodity Exchange Act by industry professionals. Since its inception, over 4,000 such claims have been filed. The SEC does not have a system of this nature, and injured securities investors must resort either to private arbitration or to court litigation in order to vindicate their rights.

H. Civil Penalties. An invaluable tool of the CFTC is its authority to assess civil penalties (up to $100,000 per offense) against violators of the Commodity Exchange Act. In FY 1981, nearly $2,000,000 in these penalties were assessed by the CFTC. The SEC has no civil penalty powers.

I. Suitability. Securities regulation has formalized certain express "suitability" rules. Generally, they focus on the type of investment recommendations that brokers should make, depending upon the customer's circumstances. If no investment recommendations are made, however, such as where an investor selects his own stocks, suitability requirements generally do not apply.

As noted earlier, there are roughly 30,000,000 stockholders in the United States, or about 20% of the adult population. Such a huge population of securities owners will inevitably embrace citizens in nearly every walk of life and every economic and social strata.

Moreover, stocks vary radically in risk. Some are "blue chip," some are "special situations," and others are "hot" or "penny" issues. Considering the spectrum of both stockholders and stocks, suitability rules are not only appropriate but essential.

But this is hardly the profile of a futures trader. As indicated earlier, there may be as few as 100,000 avocational public traders in the futures markets. A recent survey by a popular trade publication (discussed earlier) shows that, of those responding, they were well-educated and unusually affluent. Similarly, the account opening requirements of a major brokerage firm, handling an estimated one-third of public futures business, set especially high thresholds, such as a net worth of $100,000 exclusive of home and insurance.

Nor is there wide variation in the level of risk among futures contracts, as there is in stocks. All futures contracts are potentially very risky. That fact, together with onerous margin requirements and possible delivery obligations, are major reasons why only 1 in every 300 stockholders has entered the futures markets.

Thus, a "suitability" rule for futures trading is not likely to be of much regulatory value, considering the profile of futures traders and the fungibility of potential risk in all futures trading. And, since only 8% of the respondents to the trade publication survey relied on broker recommendations (the focus of suitability rules), such a requirement in the futures markets would probably apply to relatively few traders in any event.

The best "suitability" screen in futures trading is the futures contract itself. It bristles with warning signs: Short-term! High risk! Repetitive calls for more and more money! The potential for delivery! This form of suitability screen has managed to keep the public futures population under 1% of the securities population, whereas the formal "suitability" rules in the securities industry have allowed 30 million Americans into the stock markets.

Where this inherent suitability screen does not necessarily exist, such as in commodity options where a buyer has limited risk (only his premium can be lost), the CFTC has adopted special rules. Before opening a commodity options account for a customer, CFTC regulations require the broker to make a reasonable inquiry into the customer's personal circumstances and, based on that knowledge, to supply any pertinent additional information so that the customer can make an informed decision whether commodity options are right for him. This requirement is not limited to situations where the broker is making trading recommendations, as is the case in securities suitability rules. Rather, the rule must be complied with for all accounts.

J. Risk Disclosure. As noted earlier, futures contracts are potentially high-risk instruments. At the same time, they have many basic similarities in design. In addition, since an actual sale of the underlying item is rare, the type of risk involved is almost always the chance of adverse market movements during the period when the futures contract is held.

For futures contracts, CFTC regulations require the broker, before making the first trade for a customer, to deliver to him a "Risk Disclosure Statement." The exact wording of that document is prescribed by the CFTC, and the broker may not deviate from it. Delivery of the document, however, is not enough. The customer must actually sign the document, acknowledging that he has read and understood it.

The "Risk Disclosure Statement" is brief and to the point. While it sets forth each of the major risks of futures trading, it is brief enough to assure that it will be read by the customer. This brevity, together with the required signature by the customer, has proven to be a highly effective way to reach each prospective trader.

In securities trading, risk disclosure is generally found in a lengthy and hard-to-read "prospectus" dealing with a particular stock. Securities orders may be executed for the customer even before the prospectus reaches him. And he is not required, either before or after opening a securities account, to acknowledge that he has read and understood the prospectus. Considering the length and complexity of these prospectuses, it is highly doubtful that they are read by more than a few securities investors.

With respect to commodity options, a more extensive Risk Disclosure Statement is required by the CFTC. Even so, it is substantially briefer than the prospectus required for stock options. The latter, issued by the Options Clearing Corporation, is 55 pages in length, with no fewer than 53 cross-references for the reader to navigate in order to understand its content. Once again, the likelihood is remote that stock options traders will read the OCC prospectus fully or carefully. And, while CFTC regulations require a commodity options customer to sign the Risk Disclosure Statement as having read and understood it before a trade can be made, these requirements do not exist for stock options traders. Thus, while the OCC prospectus is formidable in appearance, its effectiveness as a risk disclosure document is doubtful.

K. Market Surveillance. Futures contracts are limited-life instruments. They expire during a designated month and, for that reason, traders must either exit the market through offset prior to maturity or undertake the delivery process. The CFTC monitors all contracts with great intensity, especially near their maturity. The CFTC staff surveills these contracts on a daily basis, and the full Commission meets at least once a week to review the markets. The USDA, SEC, Fed and Treasury have standing invitations to attend the pertinent parts of these meetings.

At all times, the CFTC knows both the identity and the open trades of every large participant in the futures markets. The data is generally received by the CFTC on a daily basis. In addition, the CFTC has prompt access to information about a trader's holdings in the underlying item; trades held on other markets; and other pertinent data. Through interviews with both the affected futures exchanges and individual traders, the CFTC gains information as to trading intentions (i.e., whether market offset will be used, or delivery is desired). Pertinent information is also maintained on the underlying item, such as current prices, available supplies, and political or economic developments affecting that item.

The CFTC maintains ongoing liaison with the USDA for agricultural futures; the Fed, Treasury and SEC for financial futures; the Commerce Department for international commodities; and the Energy Department for fuel futures.

The objective of this intensive market surveillance by the CFTC is to detect and, more important, to prevent the development of conditions that may distort or affect the efficiency of the futures markets. The process, in other words, is prophylactic in nature, and the CFTC is directly involved on an everyday basis.

In the securities industry, this function is performed by the stock exchanges, with the SEC in an oversight role only.

L. Emergency Powers. The CFTC has broad powers to act in any market emergency. Such an emergency may be a real or threatened market manipulation; a disruptive act of a government; or any other event that prevents the futures markets from accurately reflecting the forces of supply and demand. While the power is used sparingly, the CFTC has invoked it on four occasions since 1976. It has been used to require substantially higher deposits on certain futures contracts, to preclude new entrants into the market, and even to close certain contracts. These remedies are not limited to any particular period of time and could be imposed over very extended periods. Moreover, the CFTC is not limited in any way in the types of remedies or restrictions that it may impose in market emergencies. The exercise of this power has been held to be nonreviewable by the courts, that is, it cannot be frustrated by court action.

The SEC does not have this broad power. While it may suspend trading in a particular stock for up to 10 days without judicial action, the SEC does not possess emergency powers of the breadth or duration of the CFTC's.

M. Competition. The futures markets have been described by an economist as a form of nearly "perfect competition." Market practices and procedures assure an extremely competitive trading environment. In the largest markets, for example, there may be hundreds of traders competing on the exchange floor for the best available price for a particular futures contract. This competition not only serves to narrow the bid-ask spread for transactions, but it also allows the market to absorb very large orders. Since, by law, nearly all futures trading must be conducted on the exchange floor by open outcry, a large floor population is indispensable to the market's efficiency. As a result, transactions can be made within relatively narrow price ranges and large orders can be absorbed with little price impact.

On the stock exchanges, the markets' efficiency is restricted by various limitations on floor competition. For example, the prevailing specialist system has proven inadequate to permit floor execution of large blocks of stock. As a result, nearly 30% of the NYSE volume in 1980--3.3 billion shares--had to be transacted off the floor, between private buyers and sellers.

N. Audit Trail. As noted earlier, the CFTC maintains a unique "large trader reporting system" through which it gains daily knowledge of the trading activities of significant market participants. The SEC lacks a comparable in-house system.

With respect to routine or smaller trader activity, the CFTC has adopted a number of requirements in order to isolate particular transactions for closer scrutiny. First, all customer orders must be timestamped upon receipt by the brokerage firm, upon reaching the trading floor, and after execution on the floor has taken place. For exchange members present on the trading floor, they must indicate on their trading cards the half-hour of the session during which contracts were bought or sold for their own or related accounts. An exact timestamping system, similar to that used for customer orders, has not proven feasible for members' trades under present technology because of the open auction nature of futures markets, with large crowds of traders vying for the best available price. Requiring timestamping after each such trade would likely cause serious congestion at the location of the time-stamping equipment and, more important, could severely retard the prompt execution of waiting orders in fast-moving markets. Delays of this nature could result in unnecessary losses to customers as they "miss the market" due to the need for floor brokers to vacate their trading stations in order to timestamp trades just made for others.

In some securities markets, but not in all, a more precise time sequencing system exists for member trades. The existence of "posts" at which certain securities or stock options are traded allows a more localized use of timestamping systems. However, as indicated above, this "post" system and the use of "specialists" reduces the level of competition and, for that reason, may not result in the achievement of prices that would be attainable under the open auction procedure used in futures trading.

Moreover, not all securities exchanges have superior time sequencing systems. The Options Study conducted by the SEC several years ago indicated that the nation's largest securities market--the NYSE--does not have an adequate audit trail:

> Although more than 15 years have passed since the Special Study made its recommendations, the NYSE has not yet implemented an automated market surveillance system or an adequate audit trail. The exchange still does not have the ability to identify, on a routine, automated basis, the participants in each trade on its floor. Nor does the exchange yet maintain a record, collected at the time that orders are executed, which indicates the parties, the execution or reporting time, and the terms of each trade. . . . [T]he lack of such essential surveillance information raises a substantial concern . . . regarding whether the exchange has the ability to fulfill its statutory responsibilities on a daily basis for each stock that is traded on the NYSE floor. (Options Study, pp. 228-29.)

APPENDIX

A. Definition of Terms

"Cash settlement" in futures contracts means that an actual sale (i.e., delivery of the underlying item) is not permitted, even at the maturity of the contract. Instead, those remaining in the market at maturity either receive or pay cash, based upon the change in the contract's value during the period in which it is held. This system exists in the Eurodollar and Stock Index futures contracts.

"Long" futures contracts mean the obligation assumed by one party to receive and pay for the underlying commodity if and when an actual sale takes place. The holder of a "long" futures contract profits if prices rise.

"Offset" of a futures contract in the market involves acquiring a second contract of the same type, but with the opposite obligation from the first. If a trader initially acquires a "long" Gold futures contract for December delivery, offset is effected by his acquisition of a "short" Gold contract for December delivery. Since the trader is now both "long" and "short" in the same contract, the two are deemed to cancel each other. However, if the contracts are acquired at different prices (which is likely), the offsetting trader will be required to pay the difference (if a loss) or will be entitled to receive the difference (if a profit).

"Short" futures contracts mean the obligation assumed by one party to deliver the underlying commodity if and when an actual sale takes place. The holder of a "short" futures contract profits if prices fall.

B. Why Futures Regulatory Principles have been Adopted for Stock Option Trading.

In the late 1960's, the Chicago Board of Trade (a futures exchange) conducted research into the efficacy of futures contracts on individual securities. After pursuing that study for a considerable period, the determination was made, for both legal and practical reasons, to develop a "put and call" market rather than a futures contract.

The legal reason was principally that the then-regulator of futures markets, the Commodity Exchange Authority (a unit of the Department of Agriculture), did not have regulatory jurisdiction over futures contracts involving nonagricultural items. (This problem was solved in 1974 with the creation of the Commodity Futures Trading Commission, but too late to meet the CBOT's start-up schedule.) Accordingly, the CBOT decided to establish a separate market--the Chicago Board Options Exchange--and to seek licensing by the Securities and Exchange Commission.

The practical reason was that large segments of the securities industry were unfamiliar with futures contracts and concepts, but were better acquainted with "puts" and "calls" on securities. Thus, it was determined to revamp the program to an "options" configuration in the hope of achieving more rapid industry acceptance and use.

The final details for the CBOE were developed by a committee of CBOT members. While care was taken to conform the new exchange and its operations with SEC requirements, a number of traditional futures protections were appended: clearinghouse guarantees; speculative position limits; daily price fluctuation limits; etc. These were familiar concepts to the exchange's organizers who had traded futures contracts under those conditions for many years. At that time, those protections were entirely foreign to securities trading. The desire to create a similar environment at the CBOE was also motivated by the fact that, at the outset, the membership of the CBOE would consist mainly of CBOT members. Indeed, every CBOT member was given a free "seat" on the CBOE in recognition of the essential role that CBOT members would play in the initial years of the CBOE. And, in fact, CBOT members did provide the trading base for the new CBOE for quite some time.

Even some common securities procedures were modified to bring them more into conformity with futures trading. For instance, the specialist system common on stock exchanges was altered to permit more members to trade actively (as "market makers") on the floor. This comported with futures markets, where floor access is high and competition among a large number of traders is especially intense. And a single, uniform prospectus was developed for all options, similar to the uniformity of rules governing futures trading.

American Stock Exchange Inc.

86 Trinity Place
New York NY 10006
212/938-2407

Robert J Birnbaum
President

March 30, 1982

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Committee on Banking, Housing and
Urban Affairs
United States Senate
432 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The American Stock Exchange strongly supports the jurisdictional agreement announced by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") on December 7, 1981, as reflected, in part, in the Securities-Commodities Accord Amendments of 1982 (S.2260), which your Subcommittee is now considering. As you know, the jurisdictional agreement would provide, among other things, for SEC jurisdiction over options on securities (including exempt securities), certificates of deposit ("CDs"), and groups or indices thereof, and for CFTC jurisdiction over futures contracts on Government securities (other than municipal securities) and on broad-based groups or indices of any securities, and options on any such futures contracts. Options on foreign currency would be permitted to trade on national securities exchanges, under the SEC's jurisdiction, or in commodities markets, under the CFTC's jurisdiction. Further, no futures contracts (or options on futures contracts) on individual corporate or municipal securities would be permitted to trade until further legislation is enacted.

Prompt adoption of the proposed legislation by Congress is of critical importance, in light of the recent decision of the Seventh Circuit Court of Appeals in Board of Trade of the City of Chicago v. Securities and Exchange Commission (March 24, 1982). In a 2-1 decision, the Court set aside the SEC's February 28, 1981 order approving the proposal of the Chicago Board Options Exchange ("CBOE") to trade options on Government National Mortgage Association mortgage-backed pass-through certificates ("GNMAs"). The majority opinion is based on an interpretation of the current language of the Securities Exchange Act of 1934, as amended, and the Commodity Exchange Act, as amended, to mean that the SEC lacks jurisdiction to approve the trading of options on GNMAs, and that the CFTC has exclusive jurisdiction over futures contracts, options on futures, options on physical commodities, and options on instruments which simultaneously fall within the definitions of commodities and securities under those statutes. It appears that the majority's reasoning serves as a basis for invalidating the approvals the SEC has given to this Exchange and CBOE to trade options on U.S. Treasury securities, as well as the SEC approval we had anticipated receiving in the near future to trade options on CDs.

We believe that the Court's decision is wrong, in that it has fundamentally misunderstood the intent of Congress in establishing the CFTC and vesting it with exclusive jurisdiction over the _futures_ markets. The Court's construction of the two agencies' scope of authority may have effectively transferred a broad spectrum of securities regulation -- i.e., all options on securities and financial instruments other than corporate issues -- to an agency established primarily to regulate futures trading.

Fortunately, as the court itself noted, Congress could alter the substantive result of the decision simply by amending the statutes in question. We believe that this course of action would be in the public interest for the economic and regulatory reasons stated below, and, in particular, we strongly urge adoption of the proposed legislation which would implement the SEC/CFTC jurisdictional agreement.

Unless Congress adopts the proposed legislation in the near term, the investing public likely will be deprived of options on GNMAs, Treasury securities and CDs for a substantial period of time. While the arguments expressed in the dissenting opinion in _Board of Trade of the City of Chicago v. Securities and Exchange Commission_ would, in our opinion, support a reversal of the Court's decision on rehearing or appeal, the rehearing/appeal process will be lengthy. As the decision stands, no securities exchange may commence trading in any of the affected options until the CFTC approves such trading. We expect that the process of applying to, and obtaining the approval of, the CFTC also would be lengthy and might not be fruitful in light of the CFTC's acknowledged limited resources available for monitoring new programs, and in light of the CFTC's having limited its pilot program to options on existing futures contracts.

The need for, and economic utility of, GNMA, Treasury security and CD options to the investing public has been well documented in the numerous comment letters submitted to the SEC in response to publication of the Exchanges' proposals. In light of the facts that the SEC has already approved (or informally indicated that it expected to approve) the trading of these options on national securities exchanges, and seems well prepared to regulate trading in them, it seems unreasonable to delay their introduction pending the completion of lengthy procedures which, from the perspective of the investing public, would appear to be at best unnecessary and at worst counterproductive.

Our desire to see the SEC regulate trading in the new options under discussion is based on considerations about the efficacy of existing securities options regulation, as well as the concerns about timing expressed above. The SEC played a significant role in developing the specifications and rules relating to the stock options now traded on national securities exchanges, and has been regulating the trading of those options since 1973. Working together over the years, the options exchanges and the SEC have developed a sophisticated regulatory/surveillance/compliance framework to govern trading in stock options effectively and to protect the investing public. Since the anticipated new options would be traded within a similar framework, the depth of experience shared by the options exchanges and the SEC may be expected to result in well-run orderly markets for those options.

In comparison, the CFTC's experience relates primarily to the area of futures contracts. While the CFTC has adopted rules to govern trading in options on futures, and has approved several commodities exchange programs pursuant to those rules, trading in options on futures has not yet begun. Moreover, the development of CFTC and commodities exchange rules to govern the trading of options on physical commodities, and attendant surveillance and compliance procedures, has followed a long and tortured route and is nowhere near completion.

Although we are not completely satisfied with the terms of the SEC/CFTC jurisdictional agreement, we believe that it represents a fair compromise between the two agencies and reasonably reflects their existing areas of expertise. We urge Congress to codify the agreement by adopting the proposed legislation, in order to permit the commencement of responsible options programs which are now being delayed solely because of the jurisdictional dispute.

Very truly yours,

Robert J. Birnbaum

THE BOARD OF TRADE
of
KANSAS CITY, MISSOURI, INC.

SUITE 274 • 4800 MAIN STREET • KANSAS CITY, MISSOURI 64112 (816) 753-7500

March 30, 1982

FEDERAL EXPRESS

Senator Alfonse M. D'Amato, Chairman
Securities Subcommittee of Senate Committee
on Banking, Housing and Urban Affairs
432 Russell Senate Office Building
Washington, D.C. 20510

Attention: Ms. Diane Sanger

RE: S2260
Hearing
Wednesday, March 31, 1982

Dear Senator D'Amato:

These comments are presented on behalf of the Board of Trade of Kansas City, Missouri, Inc., often called, "The Kansas City Board of Trade," (KCBT). Please add to the record of the hearing.

The KCBT supports the Johnson/Shad agreement and the enabling legislation (S2260 on the "securities side"), and urges its adoption by the respective committees of the Senate and House, and subsequently by the full Senate and House.

Note, however, that while the KCBT fully favors the agreement insofar as it relates to the jurisdiction of the CFTC over commodity futures contracts based on broad stock indexes with cash delivery, we express no opinion on the issues relating to options on securities.

We strongly urge adoption of the two bills without any changes. The agreement was carefully constructed, and the legislative proposals carefully drafted to codify the agreement. Any changes, however slight, could easily cause the entire agreement to come apart, because of the interrelationship of the two bills.

By way of background, the KCBT was stimied for four years in its attempt to secure approval of its stock index futures contract, a vehicle which will permit hedging, or value protection, of inventories of stock owned by institutions and individuals. Approval finally occurred on February 16, 1982, following the Johnson/Shad agreement. Trading began February 24, 1982.

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From 1978 to late 1981, the CFTC failed to process the KCBT application because of its fear that such action would produce a congressional reaction stripping it of jurisdiction. Thus, the SEC effectively blocked consideration of our stock index contract by its intimidation, or influence, of the CFTC (pre-Johnson). The KCBT thought it was not appropriate for two government agencies to delay consideration of a futures contract, which by law the CFTC is charged to do, by their squabbling over jurisdiction, or "turf."

Although we have always thought the law was clear on CFTC exclusive jurisdiction over all futures contracts, (including broad stock index futures with cash delivery), the SEC challenged this for several years, until Shad was appointed chairman. The KCBT always believed the SEC knew its claim of jurisdiction over stock index futures was very weak, because while it was claiming such authority, it was lobbying to have the law changed to give it jurisdiction.

In one sense, since we believe the law is clear that the CFTC has exclusive jurisdiction over our stock index contract, arguably the codification of the agreement is not needed; especially in light of CFTC approval of the KCBT Value Line Stock Index futures contract. However, in light of some of the doubt created by earlier SEC challenges, approval appears to be desirable.

We appreciate this opportunity to express our views on this important legislation. Should the Committee have any questions, we would be pleased to respond.

Very truly yours,

W N Vernon III

W. N. Vernon III
Executive Vice President
and Secretary

blf

Financial Automation
PHLX Corporation
OF PHILADELPHIA

PHILADELPHIA STOCK EXCHANGE BUILDING
1900 MARKET STREET, PHILADELPHIA, PA. 19103
Telephone: 215/496-5025

ARNOLD F. STALOFF
President

March 30, 1982

The Honorable Alfonse D'Amato, Chairman
Subcommittee on Securities of the
  Committee on Banking, Housing and
  Urban Affairs
432 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator D'Amato:

The Philadelphia Stock Exchange ("PHLX") would like to take this opportunity to comment, for the record, upon S. 2260 and the jurisdictional accord between the Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") that this legislation would implement.

At the outset, we would like to express our strong support for S. 2260 and our belief that it should be enacted as quickly as possible. We would like to express our belief, too, that the Chairmen of the CFTC and the SEC should be commended for their mature and statesmen-like efforts to achieve a negotiated settlement of the jurisdictional disputes that have pitted the SEC and CFTC against each other, in public as well as private forums, for a number of years and stalled the exchange trading of economically useful new hedging vehicles. As a result of their efforts and the support given them by the other members of their respective Commissions, this unseemly and unproductive inter-agency squabbling has come to an end, and the limited resources of both agencies can be used more constructively.

The SEC/CFTC jurisdictional accord does not, of course, satisfy everyone. Our exchange, for example, would have preferred to see different resolutions to certain questions. However, we believe that, on the whole, this accord draws sensible jurisdictional boundaries between the commodities industry and the securities industry. Like any compromise solution, its soundness should be evaluated not on the basis of whether it makes each affected party completely happy, but on the basis of whether it achieves a fair and reasonable settlement of those parties' differences. We believe it satisfies this criterion and therefore believe it merits the support of the Congress. While we have some concern about the possibility that this accord will allow substantially identical products to be traded pursuant to disparate regulatory schemes, we assume that the SEC and CFTC will make every effort to prevent such disparities from arising and therefore feel this concern should not stand as a barrier to the prompt enactment of S. 2260.

If the SEC/CTFC jurisdictional boundaries had been drawn differently than those two agencies have proposed to draw them, one agency or the other surely would have concluded that its legitimate regulatory interests had been unduly infringed. If, for example, the SEC had been given jurisdiction over futures contracts on securities and over all option contracts on such futures, the CFTC's authority would have been substantially eroded and the Congressional desire for a unified futures market regulatory scheme would have been imperiled. If, on the other hand, the CFTC had been accorded responsibility for each new option product, including options on exempted securities and stock indexes, the SEC's ability to oversee the securities markets would have been severely constrained while the CFTC's regulatory responsibilities would have been vastly expanded. If this jurisdictional breakdown had been considered, the CFTC may well have been reluctant to jeopardize its long-term chances of surviving as an independent regulatory body by substantially increasing its short-term power over securities-related instruments. In this regard, it appears likely that pressure to merge the CFTC with the SEC could prove to be irresistible if the CFTC loses its identity as a "commodities" regulator, and that judicious preservation of the separate roles of the two agencies -- of the sort contemplated by the jurisdictional accord -- is the best way to stave off any undesired melding of their functions.

Concededly, our strong support for this accord and for S. 2260 may be colored to some extent by the fact that we have, for several years, been working to establish an exchange market in standardized options on foreign currencies. This effort has included the submission to the SEC of several lengthy "19b-4 filings" proposing to amend PHLX's rules to allow such trading to occur, extensive study of the existing foreign exchange markets and of the potential economic utility of foreign currency options and a substantial educational and marketing effort to inform PHLX members and the financial community as a whole about this proposed options product.

Our study of this proposed product and the numerous communications we have received from banks and other corporate entities have made clear to us that options on foreign currencies will serve an important economic purpose. Such options will be useful, for example, for importers and exporters who anticipate purchasing or selling a foreign currency at some point in the future and fear that an adverse exchange rate will occur prior to that time. Such options also will be useful to control the costs of borrowing in a foreign currency, to lock in the exchange value of dividends remitted from a foreign subsidiary, to curb the costs of constructing and equipping overseas facilities and to hedge the balance sheet translation risk to which corporations with foreign subsidiaries are exposed.

Moreover, foreign currency options will possess certain advantages that existing means of hedging against foreign exchange rate changes do not and will be more useful in certain types of situations. Unlike the purchaser of a foreign currency futures contract, for example, the purchaser of a foreign currency option could lose no more than the amount of his premium; and, unlike the purchaser of a foreign currency forward contract, the purchaser of a foreign currency option would be able to easily offset a hedge position that was no longer needed.

Despite their clear economic utility, however, foreign currency options have not yet become a reality, in part because of the jurisdictional uncertainty that has also served to delay the SEC-regulated trading of options on exempted securities. Because the SEC/CFTC jurisdictional accord has helped to reduce this uncertainty and has allowed the affected exchanges to focus more of their attention on the development of useful new risk transference mechanisms, PHLX believes this accord represents an important step forward. However, until this accord is ratified by the enactment of S. 2260, jurisdictional uncertainty will remain.

In light of the recent decision of the Seventh Circuit Court of Appeals, the need for prompt Congressional action has become particularly acute.1/ This two-to-one decision has imposed a judicial straitjacket on the jurisdictional accord and is therefore likely to lead to further litigation and to further delays in the exchange trading of new hedging vehicles. Indeed, both the majority and dissenting opinions appear to be looking to

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1/ See Board of Trade v. SEC, No. 81-1660 (7th Cir. March 24, 1982) (holding that the SEC has no jurisdiction to regulate the exchange trading of options on GNMAs and that the CFTC has exclusive jurisdiction over those options).

the Congress to resolve the jurisdictional questions with which the Seventh Circuit was confronted. In the final paragraph of their decision, for example, the majority justices bluntly observed that: "If the Congress disagrees with our interpretation it can of course amend the applicable statutes." And, the dissenting justice speculated that: "Perhaps all this will have a happy ending (and a warm reception from Congress). My own surmise is that the tortured analysis of the majority will gain no more attractive result in the real world than it has achieved conceptual triumph in the world of theory."[2]

When these jurisdictional issues are considered in the "real world," we believe great weight should be given to the fact that the SEC/CFTC accord represents the expert agencies' best thinking regarding jurisdictional boundaries that make sense for them from the standpoints of their regulatory purposes, capabilities and concerns. Moreover, consideration should be given to whether the jurisdiction of the SEC, "an agency of long experience and high reputation," should be "frozen and capped" while the CFTC is accorded exclusive jurisdiction over a wide range of newly developing financial instruments.[3]

In the latter regard, it should be noted that the SEC has already formulated a carefully-crafted regulatory framework for the new financial instrument option product proposals that have been submitted to it. Each of those new option products would, for example, be traded subject to SEC-approved exchange rules that: (i) impose stringent customer suitability requirements; (ii) require customer accounts to be specially approved for the particular type of option transaction in question (e.g., for GNMA options or for foreign currency options); (iii) require sales and supervisory personnel to demonstrate special knowledge regarding that type of option; (iv) require a special supervisory structure to be established to oversee transactions in those options; (v) require that customers be provided with a disclosure document detailing the special risks associated with those options and a document describing the risks of options trading in general; (vi) impose special procedures for handling discretionary transactions in that type of option; and (vii) require all options-related communications to customers to be approved in advance by designated supervisory personnel and to comport with rigid standards of fairness and accuracy. These new option products also would be traded pursuant to the sophisticated market surveillance mechanisms that are currently utilized to regulate equity options and subject to margin requirements that have been reviewed by the Federal Reserve Board as well as the SEC. In addition, these options would be traded pursuant to the substantial customer protections afforded by the securities laws and regulations.

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[2] See CBOT v. SEC, supra note 1, at 41-42 (dissent of Cudahy, J.)

[3] See id.

The regulatory safeguards that would be in place for such options are thus at least equal to those that have been approved by the CFTC for options on futures and are in certain respects more stringent than the CFTC's requirements. Moreover, the national securities exchanges that are proposing to trade these new financial instrument options have had substantial experience with the regulation of options on equity securities and would bring that experience to bear in the regulation of new option products. The Congress should thus have little hesitancy about ratifying a jurisdictional accord that gives the SEC the authority to regulate certain financial instrument option transactions occurring on national securities exchanges. Indeed, those exchanges and their Federal overseer have demonstrated that they are ready, willing and able to regulate such transactions in a manner that brings the current "state of the art" in options regulation to an even higher level.

In light of the clear economic utility of the financial instrument options proposed to be traded by the national securities exchanges and the fact that such options would be traded pursuant to the extensive customer protections detailed above, we believe the public interest would be well served by prompt enactment of S. 2260. However, based upon the Seventh Circuit's decision, we believe that one clarification should be made in this legislation prior to its enactment. Specifically, we believe that proposed new Section 9(g) should be amended to make reference to options on foreign currency entered into on a national securities exchange as well as to options on securities and certificates of deposit. If this clarification were made, Section 9(g) might read as follows:

> Notwithstanding any other provision of law, the Commission shall have the authority to regulate the trading of any option on a security or on a certificate of deposit or, if such option is entered into on a national securities exchange, on a foreign currency (but not an option on a contract for future delivery).

We believe this change will make clear that the SEC has the authority to regulate the trading of options on foreign currency if that trading occurs on a national securities exchange and will thus help to further the objectives of S. 2260 and of the jurisdictional accord.

Thank you for your consideration of these comments.

Very truly yours,

Arnold F. Staloff

Arnold F. Staloff

SIA
SECURITIES INDUSTRY ASSOCIATION
490 L'Enfant Plaza East, S.W., Washington, D.C. 20024 · (202) 488-4664

March 29, 1982

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
5300 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

Attached is a copy of the resolution adopted at the SIA Executive Committee meeting on March 10, 1982. In substance, it endorses the approach taken by the Shad-Johnson agreement as reflected in S.2260. All present for discussion on the resolution recognized that the agreement presents but one possible framework to resolve the longstanding jurisdictional dispute; and is properly subject to the legislative process. In fact they anticipate it will be modified by additional regulatory interpretation as well. The resolution was passed by the SIA Executive Committee in hope that the regulatory impasse can be expeditiously resolved and the orderly development of new financial instruments proceed.

Very truly yours,

Edward I. O'Brien
President

EIOB/cbw

NEW YORK OFFICE 20 Broad Street, New York, N.Y. 10005 · 212 425-2700

SIA
SECURITIES INDUSTRY ASSOCIATION
490 L'Enfant Plaza East, S.W., Washington, D.C. 20024 · (202) 488-4684

SECURITIES INDUSTRY ASSOCIATION
EXECUTIVE COMMITTEE MEETING

March 10, 1982

THE FOLLOWING RESOLUTION WAS ADOPTED

Be it resolved that SIA endorses the basic approach to the jurisdictional division contained in the SEC-CFTC jurisdictional agreement negotiated by Chairmen Shad and Johnson. Reasonable people may differ as to a better or more perfect plan, but the hope is expressed that this agreement can be effected without substantial legislative or regulatory changes. Regulators should provide for a measured and orderly introduction of new products in order to insure fair public markets.

NEW YORK OFFICE 20 Broad Street, New York N Y 10005 · 212 425-2700

The Mortgage Corporation
Federal Home Loan Mortgage Corporation
1776 G Street NW, P.O. Box 37248
Washington, D.C. 20013

April 14, 1982

Maud Mater
Vice President—Deputy General Counsel
Corporate Secretary
(202) 789-4730

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
5300 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

These comments on S. 2260 are submitted to the United States Senate Committee on Banking, Housing and Urban Affairs by the Federal Home Loan Mortgage Corporation ("FHLMC"). As you know, FHLMC was chartered by Congress to create and foster secondary markets in conventional mortgages.

The primary method used by FHLMC to discharge its statutory mandate is the purchase of conventional mortgages and the sale of conventional mortgage pass through securities representing interests in the mortgages purchased by FHLMC. Both the mortgage purchase and the securities sales aspects of FHLMC's operations involve puts, calls and options. Accordingly, the expanded definition of the term "security" found in sections 2 and 3 of S. 2260 would have a significant effect on FHLMC's operations. The purpose of these comments is to explain the nature of this effect and to request modifications to S. 2260 which will eliminate that effect.

A portion of FHLMC's mortgage purchase activities involves optional delivery arrangements. Typically, FHLMC will issue a fixed interest rate commitment to an institution wishing to sell mortgages to FHLMC; delivery of the mortgages can be made at the institution's option for periods as long as eight months. The institution pays FHLMC a fee for this optional delivery commitment. FHLMC attempts to match its optional contracts to purchase mortgages with optional contracts to sell securities guaranteed by FHLMC and representing interests in mortgages purchased by FHLMC. The securities purchaser, which is almost always an institutional investor or a securities dealer, will agree to purchase Mortgage Participation Certificates ("PCs") from FHLMC at a fixed yield. Delivery of the PCs is at FHLMC's option usually for periods not less than 270 days. FHLMC pays the securities purchaser or dealer a fee for this optional delivery contract for PCs.

Neither the optional delivery contracts for the purchase of mortgages nor the optional delivery contracts for the sale of PCs can be transferred without the consent of FHLMC. Therefore, a market cannot develop in optional contracts in which FHLMC is one of the parties.

FHLMC's mortgage purchase and securities sales activities do not currently require that it register as a dealer with the Securities and Exchange Commission ("S.E.C.") or that FHLMC comply with the S.E.C.'s net capital rule applicable to dealers.* PCs and other securities sold by FHLMC have been designated as "exempted securities" by the Secretary of the Treasury acting under section 3(a)(12) of the Securities Exchange Act of 1934 (the "1934 Act"). Accordingly, FHLMC's securities sales activities do not require dealer registration and net capital compliance because sections 15(a) and 15(c) (3) of the 1934 Act do not apply to exempted securities. S.E.C. Rule 3a124, which covers FHLMC's mortgage purchase operations, currently operates to classify mortgages purchased by the Corporation as exempted securities. As a result, the mortgage purchase side of FHLMC's operations also does not require FHLMC to register as a securities dealer or to comply with the net capital rule.

Section 3 of S. 2260, which expands the 1934 Act definition of "security" to include options on securities, could be interpreted to require FHLMC to register as a dealer and to comply with the net capital rule. The reason for this is the fact that section 3 classifies an option on an exempted security as a separate, nonexempted security. Since FHLMC's mortgage purchases and securities sales represent its principal business activity, FHLMC is a "dealer" as that term is used in section 3(a)(5) of the 1934 Act. With the expanded definition of security contained in section 3 of S. 2260, FHLMC's activities would no longer be confined to dealing in exempt securities, thus rendering sections 15(a) and 15(c)(3) of the 1934 Act applicable to FHLMC.

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* The FHLMC Charter Act, which has been introduced in the House and the Senate, would alter FHLMC's relationship to the United States in several ways but would not in any material fashion change FHLMC's current exemption from the securities laws.

Requiring FHLMC to register as a dealer with the S.E.C. would add significant, unnecessary costs and administrative burdens to FHLMC's operations. The costs of complying with the record keeping, reporting and employee qualification aspects of dealer registration, none of which currently apply to FHLMC, would have to be passed on to FHLMC's customers and ultimately to home buyers. No public purpose would be served, however, by requiring FHLMC to register as a dealer. FHLMC's activities are already supervised by its Board of Directtors, the three members of the Federal Home Loan Bank Board, and ultimately by the Congress. Their oversight assures the investor protection which dealer registration is intended to provide.

Moreover, since options to which FHLMC is a party are not transferable without FHLMC's consent, a public market does not exist in these options, further reducing the necessity for dealer registration. Finally, all of FHLMC's commercial counterparts on the options to which FHLMC is a party are institutional investors or securities dealers, none of which require or would meaningfully benefit from the protection of the general public for which dealer registration is designed.

Similar reasons support our position that FHLMC should not be required to comply with the net capital rule. While the net capital rule serves to protect the general public from financially irresponsible dealers, FHLMC's financial responsibility is already assured by its Board of Directors and Congressional oversight. Net capital rule compliance by FHLMC would simply add costs to FHLMC's activities with no corresponding public benefit.

FHLMC therefore requests that the language of section 3 of S. 2260 be amended to read as follows (new language underscored):

> Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)) is amended by inserting after "for a security," the following: "any put, call, straddle, option, or privilege on any security (except where one party to any such put, call, straddle, option or privilege is an agency or instrumentality of the United States) or certificate of deposit or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency.

The only effect of this language would be to eliminate the requirement that FHLMC or any other agency or instrumentality of the United States (such as the Government National Mortgage Association, the Federal National Mortgage Association or the Student Loan Marketing Association) register as a dealer or comply with the net capital rule by virtue of the fact that a portion of the agency's or instrumentality's operations involves the purchase or sale of options.* If the Committee believes that express legislative treatment of FHLMC's concerns is not necessary, FHLMC requests that the Committee Report and other legislative materials indicate the Committee's expectation that the S.E.C. will exercise administrative discretion to achieve the same results as would FHLMC's suggested amendment to section 3 of S. 2260.

Section 2 of S. 2260 would expand the definition of "security" for purposes of the Securities Act of 1933 (the "1933 Act") in fashion which corresponds to the expansion accomplished by section 3. Section 3(a)(2) of the 1933 Act currently exempts FHLMC's securities sales from the registration requirements of the 1933 Act, while section 4(5) of the 1933 Act exempts FHLMC's mortgage purchases from the registration requirement. However, section 2 of S. 2260 could result in FHLMC being required to register options transactions involving either the purchase of mortgages by FHLMC or the sale of FHLMC's securities. Registration would add significant costs to FHLMC's operations, but would not, for the reasons already discussed as to section 3 of S. 2260, provide any protection to investors.** FHLMC therefore requests that the Commitee modify section 2 of S. 2260 in the same fashion as suggested for section 3. Alternatively, FHLMC requests that the Committee Report and other legislative materials express Congress' intention that the S.E.C. promulgate exemptive rules dealing with FHLMC's concerns.

FHLMC appreciates this opportunity to express its views. If further information or an expansion of the views expressed would be helpful, FHLMC would be pleased to do so.

Sincerely yours,

Maud Mater
Vice President and
Deputy General Counsel

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* FHLMC understands that other corporate instrumentalities of the United States do engage in option writing as a part of their normal business operations. For example, the Federal National Mortgage Association issues standby commitments to purchase mortgages where delivery of the mortgages is at the option of the mortgage seller.

** FHLMC currently prepares extensive securities disclosure materials in connection with the sale of its securities. These materials describe in detail those aspects of FHLMC's securities sales programs which involve options.

Walter E. Auch
Chairman and
Chief Executive Officer

The Chicago Board
Options
Exchange

LaSalle at Jackson
Chicago, Illinois 60604 (312) 431-5701

April 6, 1982

The Honorable Alfonse D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
432 Russell Senate Office Building
Washington, DC 20510

Dear Senator D'Amato:

The Chicago Board Options Exchange, Incorporated ("CBOE") is pleased to submit this letter in support of S.2260 which will clarify the authority of the Securities and Exchange Commission ("SEC") over put and call options on registered and exempt securities, certificates of deposit and foreign currencies. S.2260 has certain complementary provisions in S.2109, the Futures Trading Act of 1982, and those provisions already have been endorsed by the appropriate Subcommittee Senate Agriculture Committee. However, there are a number of controversial features in S.2109, entirely unrelated to S.2260, which may significantly delay the passage of S.2109. In view of regulatory uncertainties created by a recent court decision, discussed below, we think S.2260 should be uncoupled from the proposed Futures Trading Act and passed as expeditiously as possible. Further, until S.2260 is adopted the securities industry cannot go forward with the introduction of a number of innovative financial products. To not adopt S.2260 promptly would be fundamentally unfair to the securities industry. The Commodity Futures Trading Commission ("CFTC") has already begun to implement provisions contained in the proposed Futures Trading Act, as evidenced by its recent approval of a new futures contract on a stock index. Yet, until S.2260 is passed, the securities industry will be stymied in its efforts to bring new products to market. Prompt passage of S.2260 is necessary to correct this fundamental inequity.

CBOE is the Nation's largest options exchange. It is registered with the SEC as a national securities exchange, and, since its inception in 1973, has been subject to the regulatory jurisdiction of the SEC. It is the only exchange that limits its activities to providing a market in securities options.

S.2260 and corresponding provisions in the proposed Futures Trading Act are needed because distinctions that previously existed between the futures industry and the securities industry are no longer clear. This lack of clarity has been the cause of a lengthy dispute between the SEC and the CFTC over which agency should regulate particular kinds of new financial products.

CBOE is probably the organization that has been hit the hardest by the uncertainties respecting the SEC's jurisdiction, and this is particularly so in connection with efforts to develop new markets in options on GNMA securities and Treasury securities. Over five years ago it came to CBOE's attention that there was a need in the United States for a regulated, reliable, hedging vehicle that would permit persons involved in housing construction and finance to hedge against changes in increasingly volatile interest rates. With the enthusiastic support and encouragement of institutions involved in home building and mortgage banking, CBOE spent over four years and over $1,000,000 developing a GNMA options market that would fill this need. In developing this new product CBOE relied heavily on years of experience in the operation and regulation of its existing stock options market. Reflecting our past experience, which included the information gathered in the SEC's extensive 1978 Special Study of the Options Markets, CBOE developed a GNMA options product that is based on the same general approach to market regulation and investor protection, including margin requirements, risk disclosure and sales practice regulation, that has proved so successful in the regulation of the stock options market.

Finally, after all of this effort and expense, the necessary regulatory approvals of the SEC were obtained. CBOE and the member firm community geared up to commence trading in the Fall of 1981. The necessary people to run the markets were hired; the participants in the securities industry were trained; the needed communications systems and other equipment were purchased and installed; the prospectus was written and registered; and the computers were programmed. Yet, the first GNMA option remains to be traded.

Shortly after the SEC approved the trading of GNMA options, the Board of Trade of the City of Chicago petitioned the United States Court of Appeals for the Seventh Circuit to set aside the order of the SEC. The Board of Trade is a futures Exchange under the jurisdiction of the CFTC, and it currently trades futures contracts in GNMAs. It apparently was concerned that CBOE's new options market might compete with the existing futures market or with a proposed market for options on these futures. The Board of Trade, later joined by the CFTC, took the position that, GNMAs became a commodity under the Commodity Exchange Act ("CEA") when the Board of Trade began trading GNMA futures on them in 1975, that the CFTC thereby acquired exclusive or concurrent jurisdiction over GNMA options, and that the SEC did not have any jurisdiction under the securities laws over options traded on a national securities exchange, even though GNMAs were themselves securities. The SEC, the CBOE and the other securities industry participants argued that the SEC has jurisdiction over the trading of options on securities on a national securities exchange under the securities laws and that such jurisdiction is not displaced by the fact that the underlying security also happens to be the subject of futures trading.

On March 24, 1982 the Court announced a 2-1 decision setting aside the SEC order. Although the majority recognized that the statutes "are complex enough to admit different opinions of their proper construction," it held that (1) although GNMAs are securities, they also became commodities under the CEA when the Board of Trade began trading futures on them, (2) the CFTC has exclusive jurisdiction (and the SEC none) over options on GNMAs securities because the options "involve" the futures contracts, (3) exchange-trades options on securities (such as those traded on CBOE, the American Stock Exchange, the Philadelphia Stock Exchange and the Pacific Stock Exchange) are not themselves securities under the securities laws, and (4) the SEC has no authority under the securities laws to regulate options on exempted securities.

The logic of the Court's decision will lead to continual expansion of CFTC jurisdiction and concomitant reduction in SEC jurisdiction whenever futures trading in a security commences. As the majority opinion stated, under the Commodity Exchange Act "literally anything...could become a 'commodity' and thereby subject to CFTC regulation simply by its futures being traded on some exchange." (emphasis added) The majority thus reads out of the Commodity Exchange Act any distinction between securities and agricultural products. The court did this regardless of the fact that ever since the enactment of the Securities Exchange Act in 1934, Congress has assigned to the SEC regulatory authority over securities and options on securities, and without any regard to the fact that the legislative history of the Commodities Exchange Act speaks to Congressional intent to save for the SEC its traditional jurisdiction. Indeed, the majority states that exempted securities are "closer in nature to traditional commodities such as corn or pork bellies, than to traditional corporate stocks."

Under this decision, the SEC and the Federal Reserve Board will lose jurisdiction over large areas for which they now exercise regulatory authority. If options are not securities, then CBOE is not a national securities exchange, and it is not at all clear what role the SEC may play with regard to public customer protection. Further, because the Federal

Reserve Board has authority to impose margins only upon securities, under this decision options will not be subject to federal margin requirements. It seems to us that the question of whether margins may be imposed on options is one that should be addressed directly by the Federal Reserve Board or by the Congress, and not decided indirectly by a court which appears to have not even considered the issue.

It also should be noted that it is not only the SEC's jurisdiction that is affected when the CFTC gains exclusive jurisdiction. State securities commissions also lose their jurisdiction. Under the Securities Exchange Act of 1934, the States play a significant role in all aspects of securities regulation. Under the Commodity Exchange Act, however, the grant of exclusive jurisdiction to the CFTC results in preemption of the basic police power of States to protect their citizens from fraudulent activity.

Much of the uncertainty created by the case will be corrected through adoption of S.2260, which contains the required securities laws amendments. S.2260 will amend the definition of security in the statutes administered by the SEC (Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940 and Investment Advisers Act of 1940) to assure that options on securities, on certificates of deposit, and on foreign currencies come under SEC jurisdiction. Section 9 of the Securities Exchange Act of 1934 will also be amended to provide that notwithstanding any other provisions of law (including the Commodities Exchange Act) the SEC will have the authority over options on securities and on certificates of deposit.

It seems to us that in view of the many uncertainties created by the majority in the Seventh Circuit decision, it would be inappropriate to delay passage of S.2260 merely in order to enact it in tandem with S. 2109, the Futures Trading Act of 1982. S.2109 is a lengthy bill with many controversial issues, such as the reach of the CFTC's enforcement processes and corresponding role of the States, registration requirements for professionals in the futures industry, procedures for processing exchange rules, streamlining reparations procedures, margin-setting authority, private rights of action, judicial review of CFTC emergency orders, agricultural options, creation of a futures self-regulatory organization and a user fee on exchange transactions.

As you know, the appropriate Subcommittee of the Senate Agriculture Committee recently approved the proposed Futures Trading Act of 1982 without the proposed provision for a user fee. Yet, the Director of the Office of Management and Budget recently has been reported as being critical of this position, and announced that it is the intention of the administration to veto that bill unless it contains a user fee provision. It seems to us that these diametrically opposite positions on a critical issue suggest that there will be significant delay in enacting the bill. Indeed, it is not inconceivable that the CFTC's charter will be temporarily extended while Congress, the administration and the futures industry come to a consensus on these issues. S.2260 thus might be held up for reasons that are entirely unrelated to its purposes.

The resulting delay would cause serious economic losses to the securities industry. As noted above, CBOE has incurred significant costs developing options on exempt securities. The entire securities industry also has incurred significant costs preparing to trade these options. We are not able to quantify those costs, but it is a significant multiple of the several million dollars expended by CBOE. At this time, those resources, such as personnel and computers, are on "hold", waiting merely for the legislation embodied in S.2260 to be enacted. For the securities industry, keeping these resources on "hold" is expensive and inefficient, and is particularly bothersome in view of the fact that S.2260 could be enacted independently of the Futures Trading Act of 1982. That would allow these resources to be put to use immediately.

For the reasons stated above, CBOE urges prompt enactment of S.2260.

Sincerely,

Walter E. Auch
Chairman and Chief
Executive Officer

The Options Clearing Corporation

April 7, 1982

The Honorable Alfonse D'Amato
Chairman
Subcommittee on Securities,
Senate Committee on Banking,
  Housing and Urban Affairs
432 Russell Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

On behalf of The Options Clearing Corporation, I am enclosing herewith a statement in support of S.2260, the "Securities-Commodities Accord Amendments of 1982". I would appreciate it if you could include our statement in the record of the your Subcommittee's procedings regarding this important legislation.

If we can be of any assistance to the Subcommittee regarding its deliberations on this legislation, please feel free to contact us.

Very truly yours,

Wayne P Luthringshausen
Wayne P. Luthringshausen
Chairman of the Board and
  President

jlk
Enc.

200 South Wacker Drive, Suite 2700, Chicago, Illinois 60606, (312) 322-6200

STATEMENT OF WAYNE P. LUTHRINGSHAUSEN
CHAIRMAN OF THE BOARD,
THE OPTIONS CLEARING CORPORATION
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
APRIL 6, 1982

On behalf of The Options Clearing Corporation, I am pleased to submit this statement in support of S.2260, the "Securities--Commodities Accord Amendments of 1982."

The Options Clearing Corporation is a securities clearing agency registered with the Securities and Exchange Commission and owned by the four national securities exchanges that provide markets for listed put and call options on securities. As the clearing house for all listed securities options, OCC provides the mechanism for settlement and clearance of options and options exercise transactions. In addition, as the issuer of every outstanding listed securities option, OCC provides the financial security that stands behind the options. Some idea of the size of the market served by OCC and the significance of its role may be seen from the fact that, as of the end of March, 1982, OCC held cash and securities margin totalling over $3.7 billion, and its clearing fund held cash and Treasury securities totalling over $200 million.

At the time OCC first began its operations in 1973, it was well understood that securities options were themselves securities within the regulatory jurisdiction of the

Securities and Exchange Commission. At that time OCC's original rules were filed with the SEC, and OCC's options were registered under the Securities Act of 1933. A year later, in 1974, Congress amended the Commodity Exchange Act to provide for a new regulatory agency, the Commodity Futures Trading Commission, which was given jurisdiction over trading in commodity futures. At that time, commodity futures generally consisted of contracts for the future delivery of agricultural products and certain other tangible commodities. Although the definition of commodity was broadened considerably in the 1974 amendments, I am confident that no one then thought that the effect of the amendments was to diminish the SEC's traditional jurisdiction over securities. OCC certainly believed that after 1974, as before, it and its securities options remained subject to the federal securities laws and the regulatory jurisdiction of the SEC. Reflecting this view, which, of course, was shared by the SEC, OCC continued to file its rules with the SEC, and to maintain its registration as a registered clearing agency. By the same token, OCC has never considered itself to be subject to the jurisdiction of the CFTC, and the CFTC has never sought to assert jurisdiction over OCC.

However, recent developments in the commodities markets regulated by the CFTC and the securities markets regulated by the SEC have caused considerable confusion over just what is the jurisdictional boundary between these two agencies.

And, as difficult as the situation had become over the past few years, it was considerably worsened late last month when a divided U.S. Court of Appeals for the 7th Circuit handed down decisions in two related cases, one of which directly involved OCC.

These decisions involved rules of OCC and of the Chicago Board Options Exchange that provide for a new market in put and call options over so-called GNMA securities, which are securities issued by the Government National Mortgage Association. These rules had been approved by the SEC, and, until stayed by order of the Court, would have gone into effect last fall. Now, however, a two judge majority of the 7th Circuit Court of Appeals has held that options on GNMA securities are not themselves securities, and thus are not at all subject to the jurisdiction of the SEC. This opinion not only has prevented the opening of the new market in GNMA options -- a market which we believe is desperately needed by the Nation's home building and mortgage banking communities -- but it has created a new set of uncertainties which, if not quickly remedied by corrective legislation, threatens to be increasingly disruptive to securities markets and to the role they play in capital formation.

Among the many new uncertainties raised by this opinion are the following:

> Does the SEC lose jurisdiction over a security that it has long regulated whenever the CFTC approves futures trading in that security?

> Does a security become a commodity, and thereby cease to be subject to the SEC's jurisdiction, if by virtue of a related futures contract, the security may be said to "involve" futures trading?
>
> Will markets in stock index or stock group futures cause the underlying stocks somehow to become "involved" in commodity futures, such that the SEC will lose jurisdiction over options on those stocks (and perhaps over the stocks themselves)?
>
> Who if anyone has jurisdiction over options trading on exempt securities such as municipals that are not at present commodities?
>
> What is the extent of the SEC's jurisdiction over options transactions and an organization such as OCC that is involved in the clearance and settlement of such transactions?

It has literally reached the point where we do not know what laws govern our activites and what federal (or, for that matter, state) agencies have jurisdiction over our affairs.

It is because S.2260 would eliminate these uncertainties that we urge its prompt enactment. The bill would draw a clear line between the jurisdiction of the two agencies by providing that options on securities fall on the SEC side of the line, and futures on specified exempt securities (and options on such futures) fall on the CFTC side. Unlike the current situation, nothing would fall between the lines. The proposal also provides for SEC jurisdiction over options on foreign currencies while retaining existing CFTC jurisdiction over futures and options on foreign currencies. We recognize that the line thus drawn represents a compromise among a number of competing interests, but we believe that the compromise is a reasonable and an acceptable one.

The entire proposal submitted to Congress by the two agencies involves amendments both to the Commodity Exchange Act and to various federal securities laws. S.2260 represents only that portion of the proposal that amends the federal securities laws, but without it, the proposal would not achieve its intended result. In fact, in light of the recent 7th Circuit holding that put and call options on securities may not themselves by securities (a holding which we believe is both incorrect and dangerous), there is now a special urgency to the prompt enactment of S.2260 in order to confirm the SEC's jurisdiction over important components of securities markets. We strongly encourage the Subcommittee to act favorably on this bill at the earliest possible time.

George D.F. Lamborn
Co-Chairman

March 31, 1982

Senator Jake Garn
5207 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

The Commodity Futures Trading Commission has proposed regulations for a pilot program under which options on certain commodity futures contracts may be traded on U.S. commodity exchanges licensed by the CFTC.

Enclosed you will find a paper recently submitted to Commissioner Susan M. Phillips by Refco International Futures, Inc. and the Chicago Mercantile Exchange regarding these proposed regulations.

Refco International is a member of the leading foreign commodity exchanges and is guaranteed by Refco, Inc., one of the major domestic commodity brokerage houses. Refco, Inc. and Refco International together provide brokerage services in every phase of the commodity futures business to commercial, institutional and selected individual accounts.

I believe several issues raised in this paper are of direct relevance to the current Congressional hearings concerning the role of the CFTC in regulating the trading of options on domestic boards of trade. Consequently, I respectfully request that it be included in any relevant Committee Hearing Records.

Yours truly,

George D.F. Lamborn/sed

George D.F. Lamborn

GDFL:sed

Enclosure

Refco International Futures, Inc. Four World Trade Center Suite 6228 New York, New York 10048/Telephone 212 432-3300

REGULATORY ADVANTAGES IN THE DESIGN OF COMMODITY OPTIONS AS FUTURES CONTRACTS

Richard A. Payne, Charles Edelsburg
REFCO International Futures, Inc.

Michael R. Asay
Chicago Mercantile Exchange

March 17, 1982

INTRODUCTION

The CFTC has proposed regulations for a pilot program under which options on certain commodity futures contracts may be traded on U.S. exchanges licensed by the CFTC.

In launching the pilot program, the CFTC has emphasized its pre-eminent concern with developing a regulatory framework for trading commodity options that would be most effective in promoting the following goals:

1. The general protection of customers trading in options.
2. Strengthening the ability of the industry to enforce its self-regulatory role in supervising the trading of commodity options.
3. Promoting the application of customer suitability standards so that the risks of option trading are both well understood and undertaken only by those financially able to sustain them.

An Alternative Design for Options: The "Futures" Option

The rules currently proposed by the CFTC would create a "stock" type option on a futures contract, requiring the buyer of an option to pay the full premium up front in cash and allowing the grantor to receive the cash premium immediately. The CFTC proposed option would create a capital asset, like a security, in contrast to a Regulated Futures Contract. The latter represents a pledge to make or take delivery of a specified commodity or financial instrument at a specified date in the future, requiring the deposit of "good faith" margin as security against default and daily marking-to-the-market.

We believe that the stated goals of the CFTC in launching the option pilot program would more likely be achieved by designing a futures option as a futures contract. In the case of a "futures" type option, the full premium (price) would not change hands in advance; instead, both buyer and grantor would make a good faith deposit (original margin) as security against default. In addition, both buyer and grantor would be equally subject to a daily cash "payment and collection" of price variation (mark-to-market).

Advantages of Options Designed As Futures Contracts

There are five major advantages to the CFTC in designing the futures option contract like a futures contract. These advantages are:

1. Superior customer protection.
2. A stronger, more financially sound market.
3. A substantive basis for distinguishing between instruments regulated by the CFTC and the SEC, providing an economic rationale for the Johnson-Shad Accord.
4. Consistent tax treatment of futures options and regulated futures contracts.
5. The ability to use existing monitoring techniques in performing financial audits and market surveillance.

I. Customer Protection

We believe that an option designed as a futures contract will increase customer protection in the following two broad areas:

1. reduce the likelihood of fraud and abuse; and
2. promote the application of customer suitability standards.

Let us elaborate upon these two points in turn:

1. The Bucket Shop Problem

Commodity option sales historically have generated public outcry because unscrupulous individuals have set up "bucket shops", selling options to the public without either hedging the positions or owning the underlying commodity. As long as commodity prices did not rise significantly, they could survive, either through the worthless expiration of the option, or through the use of funds generated by the sale of additional options to other investors to meet their obligations. If commodity prices rose substantially, however, such "bucket shops" could not meet their obligations to their option holders. In essence, they took the short side of the option position generating immediate cash but with insuffucuent financial support for such positions.

The concern for such abuse occuring tellingly demonstrates that the risks of option trading are not reduced, and the protection of the public investor is not necessarily enhanced, by simply having the holder of an option pay the entire premium up front. Options of the "stock" type, a form which has a history of abuse in the commodity marketplace, provides opportunities for unscrupulous operators. These abuses could easily be forestalled by adopting the futures contract design for options on futures.

If option contracts traded on domestic boards of trade were treated like futures contracts, no front-end premium would be paid by the buyer when the contract was entered. Rather, a good faith deposit in the form of cash or "specifically indentifiable" property would be made (equal to or less than the premium) to insure performance should the option price fall. The position would be "marked-to-market" each day, allowing the option holder to "pay or collect" his losses or profits. The absence of an initial front-end premium payment and the removal of cash from the system each day provides less of an opportunity for unscrupulous individuals to walk away with customer funds. Furthermore, any financial difficulties would be apparent immediately because payment of the customer's profit would have to be made daily. With "stock" type options, the customer's profits would not be paid until liquidation, which usually would not occur until six or twelve months after the customer purchased the option. This swells the amount of cash accumulating within the system, and increases the opportunity for fraud and abuse. A customer's losses could be much greater, since it would not be a question of one day's loss, but rather the losses occuring during the term of the option. In addition, financially unstable operators could continue selling options to other customers, thereby increasing the number of potential victims.

One concern expressed by the CFTC, regarding a "futures" option contract not requiring for the advance payment of the full premium, is that to the buyer it is a different instrument than the public knows as an "option", i.e., an instrument where all possible losses are prepaid by the buyer. It has been argued that a futures-type option, where margin calls are possible, may lead to misunderstanding both on the part of the broker and the customer concerning the total price of the option and, therefore, the customer's total potential liability.

However, the advantages of a futures-type option contract, calling for an initial good-faith deposit, come into full focus precisely when the interests of the average customer are under consideration. The "mark-to-market" system forces upon the broker and customer the discipline of constant position re-evaluation, without in any way foregoing the limited risk benefits of an option. The price of a "futures" option sets an absolute limit (less the original margin posted) on any margin calls the customers may receive.

The futures type option also provides an incentive for all market participants to atune their financial strategies to market developments. This arrangement (i.e. daily mark-to-market) will make public customers more sensitive to the risks of options trading, and will provide a natural suitability filter for those interested in entering this market.

2. The "Know Thy Customer Rule"

Another major concern of both the futures industry and the CFTC is customer suitability in option transactions. The daily "mark-to-market" of the futures contract has emerged as the best method of enforcing customer suitability standards required by the CFTC, since the customer may have a future obligation to the FCM in meeting margin calls. Consequently, the financial stature of the customer is more closely analyzed initially and is monitored on a continuous basis.

Security-type options, on the other hand, have the characteristic that when the buyer enters the contract, he has prepaid all possible losses. This feature reduces the burden placed upon the broker in assessing the financial standing of his customers. The fact that a customer can pay the premium in advance is all the relevant information the FCM requires, for he need never return to that customer again to cover losses on his position (it is incumbent upon the customer to come back to the FCM for gains). The security-type option, therefore, would allow the futures industry to lower its credit standards to the point of reflecting a "careless attitude toward option customers", in the words of CFTC chairman Johnson. The initial payment of the option price actually promotes the speculative aspects of options trading, approaching the character of a bet that must be anteed up in advance. A customer is more likely to regard the purchase of a stock-type option as an irreversible investment to be "sweated-out" should the market turn against him, rather than a position subject to constant reassessment in light of changing market conditions.

In the case of a futures-type option, there is a real financial incentive for the broker to fully understand, as well as explain this kind of option to the customer; it is the FCM who stands liable to the clearing house if the customer defaults, and it is the FCM who must contend with the burden of reparations. Consequently, in addition to the substantial sales practice audit requirements imposed by the CFTC, a futures-type option forces the FCM to do a thorough and proper job of educating the public concerning the nature of the risk/reward profile of the option, an incentive lacking in "stock" type options.

Additionally, options on futures contracts and options on physicals differ in a number of other ways. In particular, it is the futures contract which itself is marked-to-market each day, that is delivered upon exercise of futures options. Consequently, the customer must be cognizant of the mark-to-market procedures if he is to enter the futures option market. Economic properties, pricing, contract specifications, trading, and regulatory structure also are quite different. All of these subtleties of the option contract will have to be explained to the customer. Why should one feature such as premium payment be required to be treated as identical to a stock option? Since these options will be marketed by brokers familiar with futures contracts (and perhaps unfamiliar with stock options), options on futures should be as similar as possible to a futures contract.

In conclusion , designing a futures option as a futures contract would assure customer protection in the following ways:

1. Minimizes the chances for fraud and abuse. The holder of an option can withdraw any profits his position accumulates immediately. Payment for the option (i.e. the premium) is earned by the grantor incrementally, coincidentally with the incremental lapsing of the option's time to maturity (adjusted for any profits or losses on the position).

2. Sensitizes the customer to the inherent risks of option trading.

3. Implements the benefits of the mark-to-market method in promoting the application of vigorous suitability standards.

4. Familiarizes the customer with the nature of the underlying instrument on a "futures" option, i.e. a regulated futures contract.

II. Stronger and Financially Sound Market

Because "stock" type options are capital assets and because under such design the premium is passed from long to short, the integrity of the market is weaker than under the "futures" option design.

Letters of credit play a much more vital role in capital asset option systems because the short is going to demand that the the premiums be paid to him in cash since he can earn interest on the funds over the life of the contract. Consequently, the clearing houses are supported by letters of credit guarantees which, as a practical matter are drawn on a relatively small number of banks. This means the clearing house is supported by a small number of banks as well. While large bank failures are a rare occurance, such failures do occur, viz., Franklin National Bank. It should be noted that letters of credit issued by banks are not guaranteed by the FDIC or other government agency. A large draw-down on letters of credit which are not honored by the bank will result in a direct loss to the exchange.

While letters of credit would be utilized in a futures-type option design, margins are lower since the full premium need not be posted to secure the short positions. Furthermore, because less funds are tied up in the system under a "futures" option design, the potential for abuse and fraud all along the funds channels -- from customer to FCM to clearing member to clearing house -- is much less. Allowing customers to keep their money must be a much more secure form of market organization, and takes the FCM out of the banking business.

In addition to these considerations, it must be emphasized that options traded on domestic futures exchanges would be an entirely new development for the futures industry, introducing many unfamiliar concepts and procedures. It would seem unproductive and needlessly risky to introduce commodity options with a hybrid "cash/equity" approach, quite apart from the possibility of fraud and abuse such confusion might bring in its wake. Integrating options into the efficient mark-to-market method of regulated futures contracts would enhance the prospects for a successful launching of the pilot program.

III. An Economic Rationale for the Johnson-Shad Agreement

A pilot program incorporating the futures-type design of commodity options would offer a true test of its economic rationale. As presently proposed, commodity options straddle the distinctions between the capital and futures markets. Securities are capital market assets which provide a medium for channeling the savings of the economy into real capital formation. Futures contracts, on the other hand, do not channel funds between sectors, but rather are vehicles for a redistribution among market participants of the risks associated with a portfolio or a business. By facilitating the opportunity to hedge the risks of holding inventory and other cash market exposures, futures markets promote a more optimal allocation of resources throughout the economy.

Historically, the regulation of securities has rested with the SEC (at least when the "public" investor was involved) and the regulation of futures markets with the CFTC. Since capital asset type commodity options can serve either function -- a redistribution of capital as well as risk -- determining the appropriate regulator is difficult. However, if the options are designed as futures contracts, the role of channeling funds between sectors is removed, and the contract becomes a pure risk transference vehicle. This economic distinction provides a stronger reason to assert CFTC authority in regulating commodity options.

The foregoing distinction is important not simply because it clarifies the jurisdictional division between the SEC and the CFTC but also since it reflects the recognition that a futures-type option would provide the occasion for a true test of the economic usefulness of futures market options as opposed to security market options. The CFTC proposed capital asset option creates an instrument almost identical to the non-stock options being offered on security exchanges. One must question the economic justification for the dual listing of such options. Designing options as futures contracts would allow the marketplace to decide between two distinct option vehicles, providing for an economic test of the unique properties of futures-like options versus security-type options. More specifically, commercial interests could decide which option is the superior price discovery and hedging vehicle.

Given the above considerations, the creation of a "security holder" in the futures industry would appear to sidetrack CFTC resources away from its "futures" mandate.

IV. Tax Treatment of Commodity Options

Because "stock" type, capital asset options on futures contracts are a crossbreed between securities and futures contracts, their tax treatment is unclear. One of the cornerstones of the Title V tax treatment of futures contracts is daily settlement of price variation. Without this mark-to-market, options with less than one year to maturity are not subject to the straddle legislation. This means that they may be treated as ordinary capital assets. However, this creates a dilemma for the Treasury Department. The underlying instrument (the futures) and the option have different tax treatments, opening the door for tax arbitrage. This assymetrical tax treatment of stock-type options on regulated futures contracts could generate the promotion of tax avoidance schemes, undermining the purpose of Title V tax legislation.

Designing the option as a regulated futures contract (RFC) removes this uncertainty. A regulated futures option contract (RFOC), requiring an initial good faith deposit (original margin) with daily cash "payment and collection" of price variation (mark-to-market), would fall under the Title V straddle legislation. This would equate the tax treatment of the futures option with the underlying futures contract. Such consistency would protect the public and the integrity of the Title V legislation.

V. Existing Safeguards for Futures Can be Used for Futures Options

The rigid and costly set of customer safeguards the CFTC is attempting to impose on the industry because of the nature of the capital asset option premium pass-through becomes less of an issue when the options are treated as futures contracts. The same set of rules and financial controls applied to futures contracts can be directly applied to option contracts. Of particular importance are the customer fund segregation, margin and capital requirements. Current law requires that customer funds be segregated from house funds, and prohibits the use of one customer's deposits in meeting margin requirements of another customer. Under the CFTC staff interpretation, this law prohibits the use of net margining in the (joint) customer account at the clearing house.* The prohibition rests on the argument that one customer's "stock" type option (which is a capital asset and must be segregated) cannot be used to offset, i.e.,meet, the margin required on another customer's short option position. While the industry disagrees with the staff interpretation, the problem would be eliminated if options are treated as futures contracts. This is an important point, for most clearing houses use net margining procedures and moving to gross margining would be extremely costly and result in substantial operational risks in effecting the option pilot program.

Capital requirements under the CFTC pilot program are also very onerous if the capital asset option proposal were adopted. For example, the purchase of a long option will impair FCM capital by the full amount of the premium. This impairment occurs because under rule 1.17 C5Xii, the capital charge for the long option is the same as for the short option (limited to the premium); at a minimm, exchanges will require the full premium, marked-to-market, to be posted as margin for short positions. This will substantially reduce the number of positions small houses can take on the long side and decrease the liquidity of the market. Although the logic for the capital charge on the long is not known, its onerous effects disappear if the options are treated as futures contracts. The capital charges on both long and short would be limited to the margin, which could be considerably less than the premium and would reflect the true risk in the position.

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*Net margining refers to the offset, for purposes of margin, of all paired long and short positions in the FCM's customer account regardless of whether the long and short positions are actually held by the same customer.

SUMMARY

We have sought to demonstrate the advantages of designing a commodity option as a futures contract. We believe a futures-type option would promote more effectively the stated goals of the CFTC in launching the pilot program in commodity options--promoting customer safeguards and strengthening the self-regulatory role of the industry in policing the trading of commodity options. It would achieve these goals by:

1. Maintaining the proper balance of incentives necessary to preserve both the customer's interests and the integrity of the futures industry.
2. Maximizing the efficiency of the futures option market by integrating it into the finely honed futures trading system.
3. Providing the economic basis for a market test of alternative hedging and trading vehicles.

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Dr. Mark J. Riedy
Executive Vice President
(202) 861-6501

April 15, 1982

Honorable Alfonse M. D'Amato
Chairman
Subcommitte on Securities
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Mortgage Bankers Association of America* (MBA) would like to take the opportunity presented by your Subcommittee's review of S 2260, a bill to clarify the jurisdiction of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), to comment on the CFTC's reauthorization and jurisdiction and other related matters that concern both our membership and America's distressed housing market.

Considering the breadth of its regulatory responsibility, the CFTC should be commended on its contribution to the relatively smooth operation of the futures market during the past half-dozen years. This smooth operation has been especially evident to the mortgage banking industry, which has yet to experience any significant problems in the futures market. Our industry has been able to adequately hedge considerable interest rate risks arising from loan production activities in a volatile interest rate environment. Such successful hedging has benefitted the housing market and homebuyers across the Nation. We believe that the continuation of the efficient operation of the futures market is highly dependent on the continued regulatory and enforcement efforts of the CFTC.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Pension Funds
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

Our Association also believes that, in the course of reauthorizing the CFTC, Congress should take the steps necessary to permit trading of options contracts based on mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA options). These options are of great importance to our industry as well as to the entire residential mortgage market.

Jurisdiction

The CFTC and the SEC should be commended for their efforts to resolve the several jurisdictional issues between them regarding financial futures and options. These efforts have led to an agreement which appears to mark the first time since the establishment of the CFTC in 1974 that the two agencies have agreed on jurisdictional bounds. MBA supports both the spirit and the content of this agreement and urges Congress to adopt such legislation as would implement it or a similar pattern of jurisdiction. Since neither options on fixed income securities nor options on financial futures contracts have ever been tested in the marketplace, it is not possible at this time to evaluate their relative merits, except in the abstract. Thus, it appears eminently logical to allow the development of both options on securities as well as options on futures. Both futures and options exchanges should be given the opportunity to implement options on debt instruments or mortgage-backed securities, so that the marketplace has the benefit of competition between the different contracts.

MBA has submitted comments to both the CFTC and the SEC concerning the importance of exchange-traded GNMA options in our four-year effort to launch these financial instruments. GNMA options, through their use in conjunction with optional mortgage finance commitments to both homebuyers and homebuilders, are of critical importance to the housing market and to the American homebuying public. (The relationship between GNMA options and the housing market is illustrated in the attached comments, which MBA submitted to the CFTC on July 29, 1981.) Unfortunately, even with recognition by both the CFTC and the SEC of the imperative economic and commercial need for GNMA exchange-traded options, the jurisdictional uncertainties have prevented their implementation.

This continuing jurisdictional uncertainty has had some extremely frustrating and counterproductive effects on the Chicago Board Options Exchange (CBOE). The CBOE has been ready to start a GNMA options market since September of 1981. However, the start-up of trading has been blocked first by a court order and subsequently an adverse ruling from the Seventh Circuit Court of Appeals, in conjunction with a suit brought by the Chicago Board of Trade (CBOT) against SEC and the CBOE in April of 1981.

The key question raised by the CBOT in their suit is whether or not the SEC had the jurisdiction to approve the trading of GNMA options on the CBOE. Since this issue does not appear any closer to final resolution today than it did four months ago, it is unlikely that exchange-traded GNMA options will become a reality until or unless the jurisdictional uncertainies are resolved by Congressional action.

The only other potential avenue for GNMA options trading is on a futures exchange. However, the pilot CFTC options program that is mentioned in the attached comments was limited to a single financial futures option contract per exchange, and since the only futures exchange presently eligible to trade GNMA options, the CBOT, opted instead for the more lucrative Treasury Bond option, GNMA options may not be traded on a futures exchange until the pilot program ends, perhaps as long as two years from now.

Considering the important economic and commercial justification for GNMA exchange-traded options, especially relative to the other permitted and proposed options contracts, MBA hopes that the Congress will take the opportunity presented by the reauthorization proceeding and the introduction of S 2260 to remove the impediments that presently block the implementation of GNMA options trading.

In summary, MBA is very supportive of S 2260. We hope that your subcommittee can contribute to the solution of the jurisdictional question between the SEC and CFTC. Thank you for taking the time to consider our comments. We would be happy to answer any questions or provide additional information should you so require.

Sincerely,

Mark J. Riedy

Dr. Mark J. Riedy
Executive Vice President

MJR/dw

STATEMENT OF THE
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
("NASAA")

By

Tom Krebs

Director

Chairman of the Ad Hoc Committee on CFTC Reauthorization

Members of the Committee, I welcome this opportunity to present the views of the North American Securities Administrators Association, Inc. ("NASAA") regarding the lack of sufficient investor protection in connection with commodities related transactions and the impropriety of permitting trading in futures or options on stock indices.

NASAA is an association of state and provencial securities administrators from the United States, Canada and Mexico which, since 1918, has worked for investor protection. State securities commissioners are charged with promoting investor protection and regulating the securities markets in their respective jurisdictions. NASAA's activities involve cooperative enforcement efforts among its membership as well as with other law enforcement officials and certain federal agencies.

In this testimony we will address (i) the present scheme of regulation over the marketing of commodities related instruments; (ii) how that scheme of regulation compares to that one over the marketing of securities; (iii) the effectiveness of having two federal agencies regulating investing, and (iv) the problems inherent in authorizing options or future on stock indices.

The regulation of the commodities and futures markets is vested in the Commodities Futures Trading Commission ("CFTC") which is charged with maintaining a uniform regulatory scheme over such markets in order to assure an orderly and competitive system of commerce protection. Investor protection comes within that charge, but the policing of the sales practices of agents soliciting public funds in commodities related transactions is not a primary mandate of the CFTC.

Pursuant to its mandate, the CFTC has concentrated its efforts on the hedging and speculative aspects of the futures markets, rather than on monitoring the investment by the general public in the futures market. This public aspect of the futures market has grown in substantial porportion since 1974, especially in the form of "boiler rooms" which specialize in the mass marketing of commodities-related instruments to unsophisticated persons who are unaware of the risks and potential losses inherent in such investments or the persuasive pressures being placed on them.

Every year since the creation of CFTC, our country has experienced a major scandal involving commodites-related investments. Each passing year has witnessed an unchecked migration of thieves, con artists and swindlers to the commodities investment arena. Beginning with the infamous Lloyd, Carr and Company frauds, followed by commodity options, continuing through silver and gold buillion sales, to deferred delivery contracts for crude oil and coal and now with commodity pool frauds, boiler room operators have looted untold sums of money from our nation's citizens. In addition, these swindlers are often registered with the CFTC and tout such registration to give an air of legitimacy to their operations.

Why is it that investment by the general public in commodities has become synonymous with fraud whereas the same is untrue of investment by the general public in securities? NASAA believes that this situation is due in large part to:

> (1) the lack of investor protection mechanisms in commodities regulation;
>
> (2) the preemption of State law by the grant of exclusive jurisdiction to the CFTC; and
>
> (3) the complex nature of commodities instruments which makes it easy to trick the unsophisticated investor.

As mentioned previously, the CFTC does not concentrate in the policing of sales representatives who peddle various exotic commodities instruments. There are no regulatory standards regarding methods utilized by commodities sales forces. Nor is there testing of sales personnel even as to the basics of commodities laws as part of the registration process. Such standards and testing have long been an element in the securities industry. The Securities and Exchange Commission ("SEC") and/or the National Association of Securities Dealers, Inc. ("NASD") set standards for the activities of broker-dealers or registered representatives and in addition have established a series of tests to insure that securities salesmen have some basic knowledge in securities laws including the investor protection provisions. In addition, the States set standards for broker-dealers and registered representatives and certain states require representatives to take a uniform state law exam administered through the NASD.

There are no investor suitability standards in commodities regulation and such a standard was recently rejected by the CFTC, contrary to the wishes of then-Chairman James Stone, and has consistently been opposed by industry. An investor suitability standard has been long employed and accepted in the securities industry and provides an excellent self-policing mechanism for broker-dealer firms to guard against over-zealous sales personnel. The major, if not only, purpose for a suitability standard is the protection of unsophisticated investors. There is no great regulatory burden in a rule which requires a commodities salesman to ascertain that a particular investment is appropriate for his client. The volatility and highly speculative nature of commodities trading compels the conclusion that only certain investors are candidates for such investments. Those who trade in securities, a more conservative investment medium than commodities, must adhere to a suitability standard. It seems imperative commodities salesmen be subject to such a standard. The preemption of State law by the grant of exclusive jurisdiction to the CFTC in Section 2 of the Commodity Exchange Act prevents State securities administrators from combatting commodities frauds and excludes that integral element of the police force over securities frauds. State securities administrators receive numerous complaints from the constituents documenting "horror stories" in which these inexperienced investors have lost their life savings.

The complex nature of these commodities instruments make it easier for these thieves to "dupe" the unsophisticated investor. Defrauded investors rely on the misrepresentation of fraudulent salesmen for they cannot understand the contracts or other documents they receive. This factor will only be exacerbated by the authorization of options and futures on stock indices. Convicted commodities swindlers testifying before the Senate Permanent Investigations Subcommittee testified that these new instruments will open a whole new arena for scams and rip-offs.

These stock index options and futures will create a national lottery game which will have the seal of approval of both the SEC and the CFTC. On one side of these instruments will be the portfolio manager who is hedging against market fluctuations and on the other side will be the sophisticated speculator and unsophisticated investors. The purpose of these instruments are to permit hedging against market fluctuations.

In our present economy, investment funds are needed for capital formation. Small businesses are unable to find equity investors. These new instruments will create a national lottery sanctioned by federal authorities. During this period of a depressed economy, we must question a determination to authorize these instruments at this time.

At the very least, the investor protections which are an integral part of the securities markets must be applied to the commodities markets whether it is done by the CFTC or the SEC as the agency more geared for investor protection. In addition, the states must regain their basic police power to protect their citizens through a return of jurisdiction. NASAA supports HR 5515 which would suspend trading in stock index options and futures until August 1982 and would support an extension of such suspension until such time as the futures markets are no longer equated with fraud, the economy improves such that it can tolerate the channeling of money into these questionable instruments, and the regulators have more carefully reviewed the ramifications of these instruments. These speculative instruments have little if any economic purpose, but could potentially impair the underlying equity securities market.

NASAA does not advocate the termination of the CFTC but recognizes a need for a reevaluation of the regulation over investment markets by the CFTC and the SEC.

NASAA appreciates being afforded the opportunity to present its views today and I will be glad to answer any questions the members of the Committee may have.

N.Y. STOCK
EXCHANGE

Eleven Wall Street
New York, New York 10005

John J. Phelan, Jr.
President and
Chief Operating Officer

April 20, 1982

The Honorable Alfonse M. D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing and,
Urban Affairs
United States Senate
432 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The New York Stock Exchange and its wholly owned subsidiary, the New York Futures Exchange, support the jurisdictional accord announced by the Securities and Exchange Commission and the Commodity Futures Trading Commission on December 7, 1981. We believe that it represents a reasonable division of responsibility, of regulatory agencies, based on their respective areas of expertise. The accord, when enacted into law will delineate the jurisdiction of each agency and resolve issues now confronting security and commodity exchanges on the process of bringing to appropriate markets new and varying products for investors.

Unfortunately, the recent decision of the 7th Circuit Court of Appeals in *Board of Trade of the City of Chicago* v. *Securities and Exchange Commission* has reverted and added to the confusion and uncertainty existing prior to the announcement of the jurisdictional accord on December 7, 1981. The divergence of views expressed in the majority and dissenting opinions adequately demonstrate the need for clarifying amendments to existing applicable law.

As you know, the Senate Committee on Agriculture, Nutrition and Forestry has ordered reported S. 2109, the Futures Trading Act of 1982, which implements the CFTC portion of the accord. The Subcommittee on Conservation, Credit and Rural Development of the House Committee on Agriculture has favorably reported these same provisions to the full Committee.

We urge adoption of the proposed legislation, now pending before your Subcommittee, which would implement the SEC portion of the accord.

Very truly yours,

John J. Phelan, Jr.